United States Court of Appeals

for the Second Circuit

APPENDIX

74-2405

In The

United States Court of Appeals

For The Second Circuit

GERALD L. HERZFELD,

Plaintiff-Appellee,

- against -

LAVENTHOL, KREKSTEIN, HORWATH & HORWATH,

Defendant-Appellant.

LAVENTHOL, KREKSTEIN, HORWATH & HORWATH,

Third-Party Plaintiff-Appellee,

- against -

ALLEN & COMPANY, INCORPORATED and ALLEN & COMPANY,

Third-Party Defendants-Appellants.

ALLEN & COMPANY and ALLEN & COMPANY INCORPORATED,

Third-Party Counterclaimants-Appellants,

- against -

LAVENTHOL, KREKSTEIN, HORWATH & HORWATH,

Third-Party Counterclaim Respondent-Appellee.

JOINT APPENDIX

Volume II, pp. 301a – 600a

BLUM, HAIMOFF, GERSEN, LIPSON & SZABAD
Attorneys for Appellee Gerald L. Herzfeld
270 Madison Avenue
New York, New York 10016
683-6383

WILLKIE, FARR & GALLAGHER
Attorneys for Appellant and Appellee Laventhol, Krekstein, Horwath & Horwath
1 Chase Manhattan Plaza
New York, New York 10005
248-1000

POLLACK & SINGER
Attorneys for Appellants and Appellees Allen & Company, Inc. and Allen & Company
61 Broadway
New York, New York 10006
952-0330

UNITED STATES COURT OF APPEALS
FILED
DEC 24 1974
A. DANIEL FUSARO, CLERK
SECOND CIRCUIT

(2910)

LUTZ APPELLATE PRINTERS, INC.
Law and Financial Printing

South River, N. J. (201) 257-6850 | New York, N. Y. (212) 565-6377 | Philadelphia, Pa. (215) 563-5587 | Washington, D. C. (202) 783-7288

PAGINATION AS IN ORIGINAL COPY

TABLE OF CONTENTS

	Page
Certified Copy of Docket Entries	1a
Summons Filed May 18, 1971	8a
Complaint Filed May 18, 1971	10a
Answer of Defendant Laventhol, Krekstein, Horwath and Horwath Filed July 23, 1971 .	42a
Answer of Defendants Allen & Co., Inc.; Allen & Co.; Charles Allen; Lee W. Meyer & Irwin H. Kramer, Filed July 30, 1971	55a
Stipulation and Order Dismissing Action on Merits with Prejudice and Costs Against all Defendants Except Laventhol, Krekstein, Horwath & Horwath -- Memorandum Endorsed on Stipulation Setting Stipulation Aside Filed November 24, 1971	62a
Notice of Settlement With Memorandum Endorsed Approving Settlement and Dismissal and Permitting the Bringing of Third-Party Action Filed December 13, 1971	66a
Affidavit of Defendants Allen & Co., Inc. Allen & Co,; Charles Allen; Lee W. Meyer and Irwin H. Kramer in Support of Dismissal Filed December 15, 1971 . .	72a

Contents

	Page
Exhibit A - Letter Annexed to Foregoing Affidavit	86a
Exhibit B - Letter Annexed to Foregoing Affidavit	87a
Affidavit of Attorney for Defendant Laventhol in Opposition to Dismissal Filed December 15, 1971	88a
Memorandum of Defendant Allen and Co., Inc.; Allen & Co.; Charles Allen; Lee W. Meyer and Irwin H. Kramer in Support of Dismissal Filed December 15, 1971	95a
Amended Complaint Filed December 30, 1971	105a
Answer of Defendant Filed January 24, 1972	117a
Report Dated December 6, 1969 Annexed to Foregoing Answer	124a
Financial Statements Annexed to Foregoing Answer	125a
Notes to Financial Statements Annexed to Foregoing Answer	127a
Third-Party Complaint Filed January 31, 1972	131a

Contents

	Page
Answers and Counterclaims of Third-Party Defendants the Firestone Group, Ltd.; Allen & Co., Inc.; Allen & Co,; Charles Allen; Lee W. Meyer and Irwin H. Kramer Filed February 29, 1972 . .	144a
Reply of Defendant/Third-Party Plaintiff Laventhol to Counterclaim of Third-Party Defendants Filed March 21, 1972 .	160a
Report Dated December 6, 1969 Annexed to Foregoing Reply	169a
Financial Statements Annexed to Foregoing Reply	170a
Notes to Financial Statements Annexed to Foregoing Reply	172a
Opinion No. 40,745 Filed May 29, 1974 . .	176a
Affidavit of Defendant/Third Party Plaintiff Laventhol in Opposition to Motion to Amend Judgment of Third-Party Defendants Filed June 14, 1974	250a
Judgment and Order No. 74,498 Filed June 13, 1974	256a
Pre-Trial Order of Plaintiff Filed June 5, 1974	259a

Contents

	Page
Trial Transcript Dated October 15, 1973 . .	266a
Trial Transcript Dated October 16, 1973 .	266a-30
Trial Transcript Dated October 18, 1973 . .	267a
Trial Transcript Dated October 19, 1973 . .	440a
Trial Transcript Dated October 23, 1973 . .	628a
Trial Transcript Dated October 25, 1973 . .	646a
Trial Transcript Dated October 29, 1973 . .	964a
Reply Affidavit of Allen and Co., Inc. and Allen and Co. In Support of Motion to Amend Findings and Judgment Filed September 13, 1974	1067a
Notice of Motion of Plaintiff to Amend Findings of Fact and Conclusions of Law -- Memorandum Endorsement on Motion Filed September 13, 1974	1071a
Affidavit of Louis Haimoff in Support of Motion Filed September 13, 1974	1073a
Affidavit of Allen and Co., Inc. and Allen and Co. in Support of Motion Filed September 13, 1974	1080a

Contents

	Page
Affidavit of Daniel A. Pollack in Support of Motion	1082a
Decision No. 41169 Filed September 13, 1974	1086a
Amended Judgment No. 74,800 and Order Filed October 8, 1974	1099a
Notice of Appeal of Allen and Co., Inc. and Allen and Co. Filed October 18, 1974	1102a
Notice of Appeal of Laventhol Filed November 6, 1974	1104a
Stipulation Submitting True Copy Filed November 25, 1974	1106a
Defendant Laventhol's Memorandum of Law Annexed to Foregoing Stipulation Filed December 15, 1974	1108a
Certificate of Clerk Filed December 18, 1974	1116a

Witnesses

Gerald L. Herzfeld:	
Direct	266a-33, 273a
Cross	284a
Redirect	352a

Contents

	Page
Leonard H. Fell:	
Direct	358a
Cross	379a, 441a
David G. Baird:	
Direct	418a
Cross	419a
Chester P. Wadley:	
Direct	518a
Cross	535a, 574a
Redirect	587a
Recross	591a
Martin A. Scott:	
Direct	546a
Cross	556a
Recross	572a
Sam Winograd:	
Direct	594a
Cross	599a
Arnold L. Lipkin:	
Direct	602a, 677a, 906a
Cross	949a
George M. Duff, Jr.:	
Direct	635a
Cross	658a

Contents

	Page
Maurice Goodman:	
Direct	685a
Cross	688a
Lee W. Meyer:	
Direct	694a
Cross	699a
Richard M. Firestone:	
Direct	762a
Cross	808a
Redirect	814a
Recross	815a
Eli Boyer:	
Direct	816a
Cross	830a
Charles Chazen:	
Direct	835a
Cross	872a
Robert Feinberg:	
Direct	968a

Contents

Page

Plaintiff's Exhibits:

1 — Letter from David G. Baird to Messrs. Herzfeld E1

2 — Letter from Richard M. Firestone to Gerald Herzfeld Dated November 21, 1969 . . . . . E5

3 — Note and Stock Purchase Agreement Dated November 10, 1969 . . . . . E7

4 — Telegram Dated December 10, 1969 . . . . . E24

5A — Check in Amount of $255,000.00 Dated December 15, 1969 . . . . . E25

5B — Check in Amount of $255,000.00 Dated December 15, 1969 . . . . . E27

6 — Letter From R. L. Firestone to Gerald L. Herzfeld Dated December 16, 1969 . . . . . E28

7 — CPA Report of the Firestone Group Ltd. From December 6, 1968 to November 30, 1969 . . . . . E31

Contents

	Page
8 — Cover Letter to Purchasers of the Firestone Group Ltd. Dated December 16, 1969	E40
8A — Certification of Richard M. Firestone Dated December 16, 1969	E42
9 — Annual Report to Shareholders - 1970.	E43
10 — Releases	E61
11 — Time Report	E106
12 — Audit Review Questionnaire	E108
13 — Weekly Work Sheet	E113
14 — General Journal	E115
15 — Purchase and Sale Sheets Re: Monterey Nursing Home	E116
16 — Balance Sheets	E126
17 — Memorandum Dated November 21, 1969	E137
18 — Additional Entry Sheets	E139
19 — Note	E141

Contents

	Page
20 — Memorandum	E142
21 — Agreement Dated November 26, 1969	E144
22 — Agreement Dated November 22, 1969	E149
23 — Notes Dated November 30, 1969 . .	E155
24 — List of Employees	E156
25 — Memorandum	E157
26 — Letter from Rochelle Securities Corp. Dated December 15, 1969	E158
27 — Letter from General Investors Co. Dated December 11, 1969	E159
28A — Letter from Rochelle Securities Corp. Dated December 15, 1969 . . .	E160
28B — Check in Amount of $255,000.00 Dated December 15, 1969	E161
29A — Letter from N.E. Herzfeld Dated December 15, 1969	E162
29B — Promissory Note	E163

Contents

	Page
30 — Check in Amount of $85,000.00 Dated December 15, 1969	E164
31 — Letter From Jacobs, Persinger and Parker Dated December 16, 1969 .	E165
32 — Letter From Richard M. Firestone Dated November 12, 1969	E1..
33 — Certification of Richard M. Firestone Dated December 16, 1969	E173
34 — Notice to Creditors	E174
35 — Notice	E176
36 — Proof of Claim	E177
37A — Bank Confirmations and Cutoff . .	E181
37B — Request For Confirmation	E212
38 — Notes	E238
39 — Notes	E239
Defendant's Exhibits:	
A — Deposition of Gerald L. Herzfeld . .	E240
C — Letter From Morris A. Schwalb to Chester Wadley Dated November 17, 1969	E345

Contents

	Page
D — Letter From the Firestone Group, Ltd. to Laventhol, Krekstein, Horwath & Horwath	E347
E — Letter From the Firestone Group, Ltd. to Laventhol, Krekstein, Horwath & Horwath Dated May 26, 1970	E348
F — Letter From Morris A. Schwalb to Chester Wadley Dated November 17, 1969	E350
G — Minutes of Meeting Held November 13, 1969	E352
H — Releases	E357
I — Bi-Weekly Time Report	E369
J — Bi-Weekly Time Report	E371
Third Party Defendant Exhibits:	
A-1 — Agreement Dated November 22, 1969	E375
A-2 — Agreement Dated November 26, 1969	E381
A-3 — Memorandum Dated December 2, 1969	E386

Contents

	Page
A-4 — Balance Sheets From December 26, 1968 to November 30, 1969	E388
A-5 — C.P.A. Report	E396
A-6 — Agreement Dated November 26, 1969	E403
A-9 — Laventhal Consolidated Work Paper	E404
A-10 — Laventhal Work Papers	E407
A-11 — Additional Adjusting Entries . .	E418
A-13 — Laventhal Work Papers Headed "Other Deferments"	E421
A-14 — Letter From Morris Schwalb to Chester Wadley Dated December 18, 1969	E422
A-16 — Notes	E423
A-17 — Balance Sheet	E424
A-19 — General Journal	E425
A-20 — Audit Review Questionnaire . . .	E445

Contents

	Page
A-22 — Letter From Eliot Hyman to Allen & Co. Dated February 25, 1971 .	E450
A-23 — Letter From Maurice Goodway to Allen & Co. Dated October 23, 1973	E458
A-24 — Order	E461
A-26 — S.E.C. Bulletin	E463
A-27 — Accounting For Retail Land Sales	E467

A Irwin Kramer is a partner at Allen & Company and Mr. Charles Allen's son-in-law.

Q At the time you had that conversation with Mr. Kramer, did you know him to be a partner in Charles Allen & Co., Inc. and the son-in-law of Mr.Charles Allen?

A Yes, I did.

MR. POLLACK: Objection to the form of the question. There is no such company as Charles Allen & Co., Inc. There is Allen & Co. and there is a corporation called Allen & Co., Inc. They are distinct entities.

MR. CRACO: With that understanding,this might be a good moment to clarify one of the stipulated facts that we put in.

MR. POLLACK: That would be on the third-party action.

MR. CRACO: As long as you have raised the question of identity, we have stipulated, your Honor, on page 6 of the pretrial stipulation to the following statement, Item 4:

"Allen & Co., which is a third-party defendant here, never made any representations of any kind to Laventhol in connection with Firestone."

We stipulated to that on the basis of certain representations made to us by counsel for that defendant

as to the character of the various defendants Allen & Co. and Allen & Co., Inc., and he has satisfied me that Allen & Company functions in an unrelated field, and that Allen & Company, Incorporated, is the one that did the private placement involved here.

Is that a fair statement of your presentation to me, Mr. Pollack?

MR. POLLACK: The last statement that you made distinguishing between the two is a correct statement.

MR. CRACO: All right. I will reframe my question in the light of that objection and stipulation.

Q At the time you had the conversation you are about to discuss with Mr. Kramer, did you know him to be Charles Allen's son-in-law?

A Yes.

THE COURT: I am sorry, I will have to interrupt at this point. The grand jury is down to return some indictments. We will resume at 2.15.

MR. CRACO: Your Honor, may I, either on or off the record, have some guidance with respect to the calling of witnesses here? Some of them are long-distance. They are on call, but I just wondered what your intended schedule was today so that I can have them here when you need them.

THE COURT: I would like to finish this case tomorrow. I will be guided by you as to how long we have to sit today to accomplish that purpose. We will go into the evening if we have to, because Monday I have another trial starting. We were delayed here through no one's fault, but we are nonetheless delayed, and that has got my schedule upset. There are other people relying on starting on Monday, so to that end I would appreciate your putting this case in as quickly as you can, but I will sit as late as I have to to finish this case by tomorrow.

MR. CRACO: Thank you, sir.

(Luncheon recess.)

- - -

AFTERNOON SESSION

MR. POLLACK: Your Honor, may I raise two procedural matters, please?

THE COURT: Surely.

MR. POLLACK: The first is that we turned over to Mr. Craco on Monday at the beginning of the trial the deposition of his principal witness, in the partner in charge at Laventhol & Company, Arnold Lipkin. We have asked since that time on several occasions to have the signed transcript back so that we could prepare our counterclaim. It has not been returned signed. I move the Court that it be deemed signed.

I also point out to the Court that the same man signed the deposition conducted by Mr. Haimoff. The date of the signature is today, so clearly he is in town and could have signed it. Therefore, I ask that it be deemed signed.

MR. CRACO: Judge, I have no objection to its being deemed signed. It was handed to us in court on the day this trial began. Mr. Lipkin is one of the California witnesses. It is the transcript of a two-day deposition. It is that thick, and he will sign it as soon as he is finished reading it. He signed the one that he has finished reading today today, and in the meanwhile if

Mr. Pollack is inconvenienced, I have no objection to its being deemed signed until such time as it is.

THE COURT: Don't deem it signed. Have him sign it.

MR. CRACO: He is going to sign it as soon as he finishes reading it. He has to swear it's true.

MR. POLLACK: Your Honor, there is a second matter. In order to aid in the clarification of the case, at this time I would move that the third-party defendants that have not been served with process, who include the Firestone Group, Ltd., Lee W. Moyer and Richard M. Firestone, that the third-party complaint against them be dismissed for lack of jurisdiction, so that we know where we stand with respect to them, and everybody else knows where they stand.

MR. CRACO: Judge, I don't know what standing Mr. Pollack, who doesn't represent these men, has to raise that issue.

THE COURT: I suppose I could raise it sua sponte, and I do, and I dismiss it. Will you concede you didn't serve them?

MR. CRACO: Beg your pardon?

THE COURT: Do you concede you didn't serve them?

MR. CRACO: I concede I was unable to serve them.

THE COURT: The Court has no personal jurisdiction over them.

MR. CRACO: May I proceed?

THE COURT: I raised that, as a matter of fact, the other day.

MR. CRACO: I know you did, your Honor, but I thought there might be some vagrant chance that among the three witnesses Mr. Pollack was bringing in might be one of these people, and we might acquire some jurisdiction.

THE COURT: It might be.

MR. CRACO: I hope I will have an opportunity to renew my case if that should be the case.

May we recall the witness, please?

G E R A L D L. H E R Z F E L D, resumed, having been previously sworn, testified further as follows:

CROSS EXAMINATION CONTINUED

BY MR. CRACO:

Q I think when we broke for lunch, Mr. Herzfeld, I had asked you whether at the time that you had your conversations with Mr. Kramer about Firestone, you knew him to be an officer of Allen & Company, Incorporated.

A Yes.

Q And you know him at that time to be the son-in-law of Charles Allen?

A Yes.

Q Would you describe the circumstances under which you had your conversation with Mr. Kramer?

A At dinner one night, Mr. Kramer mentioned to me --

Q Before we go into the content of it, was this a dinner at your home?

A No, at a restaurant.

Q Was anybody present besides Mr. Kramer and yourself?

A Mrs. Kramer and Mrs. Herzfeld.

Q Is it fair to say that you and the Kramers have been social friends for a good many years?

A Yes.

Q In the course of the conversation at dinner that evening, was there a conversation concerning the Firestone transaction?

A Yes, there was.

Q Would you tell us to the best of your present recollection what Mr. Kramer said to you and what you said to Mr. Kramer on that subject on that occas[illegible]

A Well, Mr. Kramer didn't know that I have previously heard about the Firestone Group from Mr. Baird. He, however, mentioned the Firestone Group to me and said while he didn't personally know anything about it, his father-in-law had mentioned that it was a very attractive deal, and that there was one unit available, and would I be interested in it, and I said, yes, I would.

Q Did Mr. Kramer describe the opinion of his father-in-law or of Allen & Company, Inc. with regard to the quality of the transaction?

A Yes, he --

Q What did he say in that connection?

A In that connection he said that it was a private placement in the office that the office felt very highly about.

MR. POLLACK: Objection, hearsay.

MR. CRACO: Your Honor, Mr. Kramer is a vice-president of the third-party defendant company, and he is speaking about a transaction in the office.

THE COURT: Overruled.

Q Did Mr. Kramer in words or substance describe this to you as one of the hottest deals he had ever seen?

A No.

MR. POLLACK: Objection.

THE COURT: Sustained. Don't lead.

MR. CRACO: I am on cross-examination, your Honor.

THE COURT: I am sorry, you are right.

MR. CRACO: Do you wish to reconsider the ruling?

THE COURT: Yes, sure.

Q On the occasion of your deposition, were you asked this question and did you give this answer:

"Q Did there come a time when you discussed the Firestone Group, Ltd. with Irwin Kramer?"

Referring to pages 44 and 45:

"A One evening we were having dinner, Irwin and his wife and my wife and myself, and during the course of dinner Irwin Kramer mentioned the Firestone Group. I had already known something about it inasmuch as David Baird had mentioned it to me. Irwin Kramer apparently was unaware of the fact that David Baird had spoken with me, and he told me about this deal, that he said Charley, who was his father-in-law, told him was again the best dealer the hottest deal he had ever seen and asked me if I was interested in participating for one unit."

Do you recall having had that question asked of you and having given that answer on that occasion?

A Yes, I do.

Q Was that answer true when you gave it?

A Yes, it was.

Q Does it refresh your recollection that Mr. Kramer said that to you or something to that effect on that occasion?

A It does.

Q What is your answer, did he or didn't he?

A The answer is yes, he did.

Q One other question:

Can you identify when you had this conversation with Mr. Kramer?

A About the middle of November, '69.

Q Was it prior to your receipt and execution of the note and stock purchase agreement?

A Yes, it was.

Q Did you construe this invitation to participate as an invitation to participate in a second unit, one other than the one that Mr. Baird had invited you to participate in?

A Yes, of course.

Q So that at this point in time you had agreed to participate to the tune of two units, is that right?

A That is correct.

Q After your conversation with Mr. Kramer, did you discuss this additional participation with anyone other than Mr. Kramer or Mr. Baird?

A Well, I presume that I discussed it with my two brothers who are my partners.

Q What is your best recollection?

A My best recollection is I did discuss it with them.

Q What did you tell them?

A My best recollection is that I told them that I was offered another unit and that I had agreed to purchase it.

Q Did you tell them that Mr. Kramer's recital of what Mr. Allen had told him was substantially the same as Mr. Baird's recital of what Mr. Allen had told Mr. Baird?

A I don't recall,but most likely I did.

Q So is it fair to say that when you had this conversation about the second unit with your brothers, Mr. Baird's view and Mr. Kramer's view and their recitals of Mr. Allen's view were all resonating together in your mind?

A I would say that's a fair statement, yes.

Q Besides your brothers, did you have any other consultations with anyone else before you entered into the note and stock purchase agreement which I believe is Exhibit 3?

A None that I recall.

Q Any consultations with accountants or tax planners?

A No.

Q There came a time, did there not, when you entered into an agreement with Mr. Baird about the form of the transaction in writing?

A Yes.

Q When was that?

A In November of '69.

Q Was it before or after you signed the note and stock purchase agreement?

A I don't recall the exact date. If I may look at the agreement --

MR. CRACO: Mr. Haimoff, do you happen to have the agreement which you tendered to us on that point?

(Paper handed to Mr. Craco.)

Q I show you a document which has been marked in evidence as Exhibit 1 on this part and ask you whether that is the agreement to which you referred.

A Yes.

Q And does it refresh your recollection as to when you entered into it?

A I note that it is dated November 1969 without a specific day.

Q But with a blank?

A With a blank.

Q Was it before you entered into the note and stock purchase agreement, which is Exhibi5 3?

A I don't recall.

Q Is this the agreement which you entered into with Mr. Baird on that occasion?

A Yes, it is.

Q While we are at it, I notice that the agreement

is addressed to Nathan E. Herzfeld, Saul S. Herzfeld and Gerald L. Herzfeld. Just for the record, are Nathan and Saul your two brothers?

A Yes.

O At the time you executed Exhibit 1 did you have any further conversations with Mr. Baird about the prospects of the success of Firestone?

A None other than what I have already testified to.

O Did you have further conversations to the same general effect as that which you have already testified?

A I had -- I believe --

O On that occasion when you signed the agreement.

A I don't believe that -- I don't believe that Mr. Baird was present when I signed the agreement. I signed the agreement for one unit and Mr. Baird signed the agreement for the second unit; and I think that he signed his agreement in his office and I signed my agreement in my office.

O We have got agreements upon agreements. I am talking about Exhibit 1, the agreement with Mr. Baird.

A Oh, I'm sorry, I thought you were talking about the stock purchase agreement.

O Just to shorten this, is it fair to say that at the time that you and Mr. Baird both signed Exhibit 1,

the Baird agreement, you had a further conversation about the prospects for the Firestone Group?

A I don't know. I don't know whether we were both present in one office when this was signed or whether I signed it and then sent it down to Mr. Baird's office.

Q In connection with the signing of that agreement, whether at the time of its signing in person or immediately prior to it, did you go through a conversation with Mr. Baird in which the substance of your previous conversations was reconfirmed to you?

A I don't recall that. I had one or two conversations with Mr. Baird. I don't recall specifically if I did or didn't have a third one which was repetitious.

Q In any event it was arranged, was it not, that Mr. Baird would purchase one of the units pursuant to the terms of Exhibit 1?

A That is correct.

Q Does that refresh your recollection as to whether or not Exhibit 1 was entered into prior to the execution of the note and stock purchase agreement?

A No, it doesn't.

Q Now, I'd like to direct your attention please to Exhibit 3. The note and stock purchase agreement; and perhaps you'd be kind enough to have that before you as I ask

you certain questions.

A Okay.

AFTERNOON SESSION

2:30 p.m.

GERALD L. HERZFELD, having been previously duly sworn, resumed the stand and testified further as follows:

CROSS EXAMINATION

BY MR. CRACO (Continued):

Q When did you receive Exhibit 3, Mr. Herzfeld?

A Sometime in November, 1969.

Q Is it prior to November 24, 1969?

A I don't remember the precise date, but I believe it was.

Q How do you fix that?

A Well, I note that this is dated November 10th, so I presume it was before November 24th, or whatever date you mentioned.

Q Is Exhibit 3 executed and dated?

A It is executed. I don't see the date on it. Do you?

Q All right. Do you remember when it was executed, just for the record?

A Approximately at this time.

Q Being the late part of November, 1969?

A The middle or later part of November, '69.

Q How did you receive it, do you recall?

A I don't know whether it was delivered by messenger or came through the mail.

Q You have no recollection --

A My best recollection is that it was hand delivered, but I am not positive about that.

Q In any event, you have no recollection of its having been mailed to you, is that right?

A That is correct.

Q Now, your testimony, as I understood it, was that you read that whole document?

A That is correct.

Q And particularly you read the income statement which is page 2 of Exhibit, is that right?

A That is correct.

Q And I believe your testimony was that you looked at this and calculated a value for the shares that you were purchasing based on a ten times earnings ratio which yielded a value in your mind of $20 a share, is that accurate?

A Yes, sir.

Q When did you do that?

A At the time I reviewed this statement.

Q Prior to your signing it?

A Yes, sir.

Q Did you discuss that computation with your brothers?

A I presume so.

Q What is your best recollection, did you or didn't you?

A My best recollection is that I did.

Q And in the course of that calculation, I take it that you computed that the earnings were something in the order of $2 a share, is that right?

A That's right.

Q Now, would you tell the Court, please, by reference to Exhibit 3, page 2 of Exhibit B attached to the --

THE COURT: Do any of you happen to have a copy of this for me?

MR. CRACO: I do. May I hand this up? I can look over the witness' shoulder.

MR. HAIMOFF: I have another copy you can use. I know it pretty well.

Q Would you tell the Court how you calculated earnings of $2 per share from that page?

A Well, I believe there were 650 or 60,000 shares issued --

Q I think it would be helpful. I am sorry to interrupt you.

A 650 or 660,000 shares issued and the earnings were $1,350,000 or $1,360,000.

Q Where do you get that from?

A The bottom of page 2. Net income $1,360,000.

Q Are you referring to the last item combined net income, $1,360,000, which is the result of a series of calculations in Note A? Is that what you are referring to?

A I am referring to the bottom figure which says combined net income $1,360,000.

THE COURT: I'm sorry. I'm not with you. Where are you?

MR. CRACO: Page 2 of Exhibit B. I think it is probably --

THE COURT: Exhibit B to Exhibit 3?

All right.

MR. CRACO: Page 2, the income statement.

THE COURT: All right.

Q My question is whether the figure you are referring to is the figure that appears to be the result of a calculation contained in Note A to the income statement?

MR. HAIMOFF: If your Honor please, I object to Mr. Craco's characterization. The figures speak for themselves.

MR. CRACO: I am trying to find out what the

witness --

THE COURT: Overruled.

MR. HAIMOFF: There is no calculation.

THE COURT: Overruled. I don't want a debate here.

MR. CRACO: May I have the question reread to the witness, your Honor? He forgets it.

(The question was read.)

A The figure I referred to is part of Note A. I don't know how to answer your question more specifically than that, Mr. Craco.

Q Is that figure the result of the calculation contained in Note?

A Well, let me see.

THE COURT: You mean the item combined net income?

MR. CRACO: Yes, sir.

A Yes.

Q It is?

A It is.

Q You did not compute, I take it, the earnings per share by reference to the projected net income in the body of the income statement itself which amount is $315,000, is that right?

A No. No, I did not. This 315, you mean?

Q I am referring to the $315,000 as the projected

net income in the body of the report itself, projected net income, $315,000. Do you see that?

A Yes.

Q Did you use that figure, projected net income after taxes, in figuring your earnings per share?

A No, I used the figure below it of $1,360,000.

Q In the investments you make based upon earnings per share and price/earnings ratios, do you not use the net income after taxes as the numerator of the fraction you employ in that calculation?

A I would say it would depend upon the nature of the security.

Q I am not talking about the multiple that you apply; I am talking about whether you don't use net income after taxes in order to compute what the net income per share is.

A No, I wouldn't use that in a certain type of transactions, depending upon the nature of the business.

Q You don't?

A Not always.

Q Ever?

A Not always. I can't say ever.

Q Did you consider using it in this transaction?

A In this transaction, as --

Q Yes or no, did you consider using it?

A Did I consider using what, Mr. Craco?

Q The net income after taxes, the $315,000, as the numerator of the fraction, the denominator of which is 665,000 shares.

A I don't know. I can't answer that question honestly.

Q I only want you to answer questions honestly.

MR. HAIMOFF: I don't understand this fraction Mr. Craco is referring to.

THE COURT: Rephrase the question.

MR. HAIMOFF: It is a price-earnings ratio of ten times something.

THE COURT: The objection is to the form of the question?

MR. HAIMOFF: Yes.

THE COURT: Sustained.

Q In order to get the value of the stock of $20, you had to first calculate, did you not, the value of the stock -- the earnings per share?

A Yes.

Q And then you applied a multiple to that earnings per share which in your judgment was appropriate to the industry, is that correct?

A Correct.

O My question is, was the earnings which you multiplied by ten, the earnings per share, not the result of a fraction, the earnings being the top part of the fraction and the number of shares outstanding being the bottom part of the fraction? Isn't that the way you calculate earnings per share, you divide the earnings by the number of shares?

A The answer to that is yes.

THE COURT: Isn't that repetitive?

MR. CRACO: Your Honor sustained a question as to form.

MR. HAIMOFF: You didn't ask that question before. You didn't refer to outstanding shares.

THE COURT: Let's move on to something else. I get it.

O In the top part of that fraction, don't you use the earnings, the net earnings, after taxes in the ordinary course of your investment practice?

A Generally, yes.

O Did you use them here?

A I have already testified --

O Yes or no, did you use them here?

A I don't even know. I would have to again look at this here. I told you what I did use.

Q You did not use the figure labeled projected net income, $315,000?

A No, I did not.

Q All right.

MR. CRACO: May I have, Mr. Haimoff, Exhibits 6 and 7.

(Handed to Mr. Craco.)

MR. CRACO: At this point, your Honor, I think it would be appropriate to draw your attention for the continuity of the record to item 9 of the pretrial order which reflects the delivery of the letter, which is Exhibit 6.

Q Just for the sake of the record, did you receive those two documents, Exhibits 6 and 7, together?

A Yes.

Q And how did you receive them?

A I don't recall if they were mailed or hand delivered.

Q What is your best memory?

A I don't remember.

Q You have no recollection of their having been mailed to you, is that right?

A That is correct.

Q My understanding of your testimony was that when

you got those two documents together you read Exhibit 6 but did not read in full Exhibit 7, is that correct?

A That is correct.

O The letter which is Exhibit 6 is dated December 16, 1969. Is it correct to say -- I think there is a stipulation but just to make sure the record is clear, is it fair to say that you received that on or shortly after December 16, 1969?

A Yes.

O And Exhibit 7 with it?

A That is correct.

O Now, did you read Exhibit 6 with care?

A Yes.

O Did you note that there was reference in that letter to certain changes from the note and stock purchase agreement?

A I believe I recall that, yes.

O Did you read the portions of the letter relating to those changes with care?

A Yes.

O Drawing your attention to page 2 of the letter, did you read and understand that portion of the letter -- I'm sorry. I want to direct your attention instead to the first page of the letter.

THE COURT: Withdraw the question.

MR. CRACO: I withdraw the question.

O Did you read that portion of the letter which introduced the changes and said as follows:

"In the course of preparing the certified statements, our auditors advised us that conservative accounting practices made certain adjustments necessary."

Did you read that?

A Yes.

T2b

Q And you understood it?

A Yes.

Q And you then read the subsequent portions of the letter.

Tell me, Mr. Herzfeld, did you understand the portions of the letter which followed that to be an attempt on the part of the Firestone Group to explain the reasons for the changes and their effect?

A I will have to read it again, Mr. Craco. Give me a moment.

(Pause.)

THE COURT: Could you give me something so I can follow this? The poor jurors can's ask questions like this. No wonder they tear their hair.

Where are you?

MR. CRACO: Your Honor, I referred the witness to the bottom of the first full paragraph on page 1 -- of the second full paragraph on page 1, and having elicited his testimony that he read and understood that portion of it, I have asked him whether the subsequent portions of it in his mind constituted an effort on the part of Firestone to explain the effect of those changes.

THE WITNESS: The answer to that question is yes.

Q Now, you read Exhibit 6, did you not, before you picked up Exhibit 7?

A Yes.

Q Now, looking at Exhibit 7 --

MR. CRACO: Do you have another copy of Exhibit 7 so I can hand it up to the Court? My copy is marked up, unfortunately.

(Document handed to Court.)

MR. CRACO: I will look over your shoulder.

THE WITNESS: Surely.

Q Referring to Exhibit 7, Mr. Herzfeld, and moving past the cover for a moment, did you read the opinion of the auditors contained on the first page of that exhibit?

A No.

Q So you did not know on December 16, or shortly thereafter, what the opinion of the auditors was with respect to the financial statement of the Firestone Corporation as to which the financial papers thereafter were prepared, is that correct?

A That's correct.

Q And I take it you didn't read the balance sheet?

A That's right.

Q And you read, I think you testified, the page headed, after an appropriate title, "Consolidated Statement

SOUTHERN DISTRICT COURT REPORTERS
UNITED STATES COURT HOUSE
FOLEY SQUARE, N.Y., N.Y. 10007 TELEPHONE: CORTLANDT 7-4580

of Income and Retained Earnings"?

A Yes.

Q You looked at that page, in any event, right?

A Yes, I did.

Q And you looked particularly at the line marked "Deferred Gross Profit," is that right?

A Yes, that's right.

Q Which was $1,795,500, right?

A That's right.

Q Now, did you notice when you looked at that line that immediately after the label there is parens, this is quoting, "(Note 4)"? Did you notice that?

A I notice it now. I presume I noticed it then.

Q But that didn't drive you, then, to read Note 4, did it?

A I never saw a note that stated that the entry was false. I didn't bother to read the note.

Q You were impressed --

THE COURT: Strike out the answer.

Answer the question, did you read Note 4.

THE WITNESS: No, your Honor.

THE COURT: Please save the arguments for your lawyer. Just answer the questions. We will move along faster.

Q And you read and were impressed, I think your testimony was, by the line: "Deferred Gross Profit of $1,795,000," but it is fair to say you were not sufficiently impressed by it to find what explanatory note was appended to it, is that fair to say?

A Yes.

Q And in point of fact you didn't read any of the notes attached to that financial statement, did you?

A No.

Q Now, you are familiar with financial statements?

A Somewhat.

Q Is your company publicly or privately held?

A Privately.

Q Have you ever seen a financial statement of a publicly-held corporation of which the notes were not an integral part?

A Yes. Yes, I would say so.

Q Did you regard the notes not to be an integral part of that financial statement?

A Yes, I didn't regard them as integral. That is why I didn't bother to read them.

Q Is that true of the page to which you have just referred, the consolidated statement of income and

retained earnings, notwithstanding the last line on it reads: "See notes to financial statement"?

A And the question?

MR.CRACO: May I have it read back?

(Question read.)

A I don't understand your question, Mr. Craco.

Q You did not regard the notes to the financial statements as an integral part of the income statement notwithstanding the fact that the very last line of the page says: "See notes to financial statement"?

A No, I did not.

Q Did you read any other line on the income statement besides the deferred gross profit? Yes or no first.

A I know that what I looked at was the deferred gross profit of $1,790,000, and that confirmed the impression that I had from the unaudited statement and that was really all I was looking for, the profitability of the company.

MR. CRACO: I move to strike that.

THE COURT: Yes, strike it out.

Q Did you read any other line of the consolidated income statement but the one for deferred gross profit?

A Yes.

Q Particularly, did you read the line referred to as net income?

A I read all of it --

Q You did read net income?

A Yes.

Q And did you see the net income, when you read it in the audited statements, was $66,916?

A Yes.

Q And did you recall when you read that figure that the projected net income for the same period on the unaudited figures was $315,000?

A No.

Q You didn't remember that?

A No.

Q Youdidn't lay those two documents side by side, did you?

A No, I did not.

Q In the process of trying to determine whether Exhibit 7 confirmed the projections of Exhibit 3, you didn't physically compare them, did you?

A No, I didn't.

Q Did you go so far in reading the income statement of Exhibit 7, the Laventhol report, to find out that Laventhol had done the calculation of earnings per share

and displayed it on that sheet?

A No, that I don't see on this sheet.

Q Do you see as the last line in the --

A Oh, yes.

Q You see it now?

A Yes.

Q Did you see it then?

A I don't know.

Q What is the earnings per share shown by the Laventhol audited statement for this period ending 11/30/69 as shown by this exhibit?

A 10 cents a share.

Q And do you say, sir, that the earnings per share of 10 cents confirmed your prior impression that the earnings were $2 a share?

A No, no, certainly not.

Q All right. Now, the fact is, isn't it, Mr. Herzfeld, that in reading the financial statement to the extent that you read it you accepted whole cloth the explanations that were given in Exhibit 6, Firestone's letter transmitting it ?

A Absolutely not.

THE COURT: What was your answer?

THE WITNESS: Absolutely not.

Q You read Exhibit 6 and the explanation and only glanced at Exhibit 7 and that particular line that you referred to, is that right?

A That's correct.

Q Was the deferred income item explained in Exhibit 6?

A I don't remember. I will have to look at Exhibit 6.

Q Take a look and refresh your memory.

(Pause.)

A Yes, it is explained.

Q Is it explained in Note 4 of the Laventhol statement?

A No, it is explained in Paragraph 3 of the letter.

Q Is it also explained in Laventhol's Note 4?

A Well, you want me to turn to Note 4?

Q It is about time.

A You asked me to look at the letter, not Note 4.

Q I am asking you whether it is also explained in Note 4.

A Yes, it is explained in Note 4.

Q And is it not fair to say that when you received them you read and accepted the explanation in the letter which is Exhibit 6 and didn't even read the explanation

in Note 4? Isn't that so?

A I guess that's so, yes.

Q What would the stock value of Firestone have been comparable to the $20 you mentioned before if you had used an earnings per share of 10 cents in your calculation?

A One dollar.

Q By the way, when you read this statement on page 1 of Exhibit 6 that the auditors in preparing the certified financials had advised Firestone that conservative accounting practices made certain adjustments necessary, to what did you understand these adjustments had to be made?

A I think the question is too general to give you a specific answer.

Q All right. Isn't it accurate to say the adjustments were adjustments to the projected financials that had been furnished to you as Exhibit B to the note and stock purchase agreement?

A Yes.

Q That's what they are, right?

A Yes.

Q Did you not understand from that that Firestone was telling you that the Laventhol audited statements were more conservative in their treatment than the projected

financial statements which you had before you when you signed the note and stock purchase agreement?

A That was my understanding.

Q And you accepted that at the time, did you not?

A Yes, I did.

MR. CRACO: Now, Mr. Haimoff, we have agreed to the marking of Exhibit 8, the Deer letter. Do you have the Deer letter?

MR. HAIMOFF: Just a minute.

MR. CRACO: May I ask you whether we can mark the certificate of Firestone?

(Pause.)

MR. CRACO: Let's see if we can do without it.

MR. HAIMOFF: I would like to have it.

MR. CRACO: You haven't offered it, and I was only going to use it to refresh --

MR. HAIMOFF: Here it is.

(Mr. Haimoff handed a paper to Mr. Craco.)

Q I show you Exhibit 8 for identification, which has been marked, your Honor, by agreement of counsel, and ask you whether you have seen that letter before.

A Yes.

Q Did you receive that letter at the same time that you received Exhibits 6 and 7?

A I understand your question. I don't remember the answer.

Q How did you receive it?

A I don't recall.

Q Did you receive at the same time the en-

closures which are referred to in Exhibit 8?

A At the same time as I received the letter?

Q Yes.

A Yes.

Q Was one of those enclosures a certificate of the president of Firestone?

A Yes.

MR. CRACO: Do you have Exhibit 9 or whatever exhibit it is, the Firestone certificate?

(Pause.)

MR. CRACO: Well, to save time, may this be marked Exhibit 8-A for identification?

THE COURT: Mark it.

xx (Plaintiff's Exhibit 8-A marked for identification.)

Q I show you Exhibit 8-A for identification and ask you whether that is the certificate of Firestone Corporation which you got on or shortly after December 16, 1969.

A Yes.

Q Did you read that when you got it?

A I believe so, yes.

Q I can't hear your answer.

A I believe so. I don't recall.

Q Does it refresh your recollection as to whether you did by my drawing your attention to the second enumerated paragraph of that?

A I believe that I did read this at the time.

Q You read that?

A I believe so, yes.

Q In particular did you read that, "Between November 30th and the date hereof there has been no material adverse change in the consolidated condition, financial or otherwise, of the company"? Did you read that?

A Yes.

Q Did you believe it?

A Yes.

Q Did you accept it as one of the things that you had before you on the 17th when you were examining the matter?

A When I was what?

Q Examining the Firestone materials that had been sent to you on about that date.

A I don't recall if I had that particular document.

Q One more item and I think I will be through. I draw your attention to the amended complaint filed by you in this action. Do you have it before you?

A Yes.

Q I call your attention particularly to Paragraph 7 of the amended complaint. Do you see it?

A Yes.

Q Have you read it?

A Yes.

MR. CRACO: Does your Honor wish it?

(Paper handed to the Court.)

MR. HAIMOFF: Your Honor, I think it only fair to say that I have just now observed for the first time that there appears to be a typographical error. It says December 6. Is that the point you are making?

MR. CRACO: No, sir.

MR. HAIMOFF: It should be December 16.

MR. CRACO: So that the record is clear, I will consent to a stipulation to amend the pleading to change the date in the last line of Paragraph 7 from December 6 to December 16, 1969, since that is not the point I am about.

THE COURT: All right.

Q Is that paragraph true as it stands, Mr. Herzfeld?

A Yes.

Q Is it in fact true that Firestone sold to you securities in the aggregate amount of $510,000?

SOUTHERN DISTRICT COURT REPORTERS
UNITED STATES COURT HOUSE
FOLEY SQUARE, N.Y., N.Y. 10007 TELEPHONE: COrtlandt 7-4580

A Yes.

Q Is it not a fact, sir, that one-third of the securities were bought by your brother, Nathan, and one-third of them were bought by your brother, Saul?

A No, no, they were bought by me as agent for the three of us.

Q Who put up the money?

MR. CRACO: Do you have the checks handy?

A Just a moment. The money was put up by General Investors, which is a partnership of the three of us.

Q Let's take these two transactions.

THE COURT: Did you say a partnership of the three of you?

THE WITNESS: A partnership of my two brothers and myself, your Honor.

THE COURT: All right.

Q There were two transactions, weren't there?

A Yes.

Q One each for $255,000, and you paid, did you not, for each of those units by a bank check?

A That's correct.

MR. CRACO: May I have the bank checks?

(Mr. Halmoff hands papers to Mr. Craco.)

MR. CRACO: May these be marked?

THE COURT: Just mark them.

MR. CRACO: They are already marked, I am sorry. May I have 5-A?

THE COURT: Do you have photostats?

MR. CRACO: No, I don't, sir, or I would use them.

THE COURT: Didnt you have examinations before trial?

MR. CRACO: Yes, sir, and we demanded the production of these, and they were not produced for many months thereafter.

THE COURT: Why did you wait so long to tell me? The object of that is to avoid just this kind of housekeeping problems during the trial.

MR. CRACO: I understand. I think they are now solved, your Honor.

Q I direct your attention to Exhibits 5-A and 5-B and ask you whether those are true and accurate Xerox copies of those two bank checks.

A Yes, they are.

Q Where did the funds come from for the bank check that was issued by the Chase Manhattan Bank?

A General Investors at this time made a loan of $255,000 from a secondary banking group called Rochelle

Securities, and Rochelle caused Chase Manhattan to issue this check.

Q Was that loan reflected by a note?

A I believe yes.

Q Who signed the note?

A I don't know whether -- I presume I signed it.

Q Are you sure of that?

A No, I am not positive. I have to look at the note.

Q I show you Exhibit 29-B and ask you if that refreshes your recollection that the note was in fact signed by you and your two brothers.

A That is absolutely correct. The note was signed by my two brothers and myself.

Q And it was pursuant to that note that Rochelle put up the money which resulted in the Chase Manhattan Bank check?

A Absolutely.

Q Where did the money come from for the check which is Exhibit 5-A issued by the Century National Bank?

A That came out of the funds of General Investors on deposit at the Century National Bank.

Q Is that a fact? I show you Exhibit 30 for identification and ask you whether that doesn't refresh

your recollection that the funds for that purchase were developed by three checks, one each signed by yourself, your brother Saul, and your brother Nathan?

A Three checks drawn on Century National Bank, yes.

Q For how much each?

A $85,000.

Q Is it not fair to say that the economics of this transaction and the checks and the notes by which the funds for the purchase were put up reflect that you and your brothers each purchased one-third of the $510,000 for which you alone sue?

MR. HAIMOFF: If your Honor please, I object to that on the ground it calls for a legal conclusion.

MR. CRACO: I am sorry, I didn't hear the nature of the objection.

MR. HAIMOFF: On the ground it calls for a legal conclusion as to the effect of the documents. I believe they speak for themselves.

MR. CRACO: I press the question.

THE COURT: I will take the answer.

THE WITNESS: I am sorry. Would you repeat it?

THE COURT: Didn't the three of you buy it?

THE WITNESS: Yes, your Honor.

THE COURT: Equally?

THE WITNESS: Yes, your Honor.

Q So that in fact you, Gerald Herzfeld, the plaintiff in this case, only put up one-third of $510,000?

A Yes.

Q But you sue for the entire amount?

THE COURT: This is argument.

MR. CRACO: Beg your pardon?

THE COURT: Isn't this argumentative?

MR. CRACO: I will withdraw it.

THE COURT: And obvious?

MR. CRACO: I will withdraw it.

2 THE COURT: We will take a short recess. How long do you expect to be?

MR. CRACO: I am finished but for one short line of questioning, very short.

THE COURT: Perhaps we will let you finish it. Then we will recess.

MR. CRACO: All right.

Q Did there come a time when after the litigation was commenced by you against Lavanthol and everybody else in this courtroom that a settlement was effected? between you and others on the one hand and everybody in this courtroom but Lavanthol?

MR. BRINN: Excuse me, Mr. Baird was not a defendant. You mentioned him. I want to make it clear. You said everybody else. That is not true.

MR. CRACO: Well, I better be less colloquial and more precise.

Q You commenced an action against a body of defendants other than Laventhol, Krokstein but including them, right?

THE COURT: Isn't this something of record?

MR. CRACO: Yes.

MR. HAIMOFF: It's part of the order, your Honor, the pretrial order stipulated.

MR. CRACO: All right.

Q Pursuant to that settlement, you discontinued the action against all the defendants you had named other than Laventhol; is that right?

A That's right.

Q It is also a fact, is it not, that Laventhol was not informed that those negotiations were proceeding while they were proceeding?

A To my knowledge they were not.

MR. HAIMOFF: I object to it, your Honor.

MR. CRACO: It's been asked and answered.

Q Did you receive a sum of money in connection

with that settlement?

A Yes.

Q How much?

MR. POLLACK: Objection, your Honor. No inference may be properly drawn with respect to the disposition of another litigation.

THE COURT: Overruled.

MR. CRACO: I think I am entitled to find out in mitigation of damages.

THE COURT: Do you want me to change my mind? I overruled the objection. You weren't listening.

MR. CRACO: I didn't hear you.

THE COURT: You weren't listening. That is par for the course.

THE WITNESS: You asked me how much?

THE COURT: How much did you get?

THE WITNESS: $357,000.

Q Did that sum include any amount that you received in connection with the plan of arrangement entered into and approved by the Firestone Corporation?

A Yes, it did.

Q How much was that?

A I believe $51,000 of the $357,000. I'd like to verify the figure, but I believe that's it.

SOUTHERN DISTRICT COURT REPORTERS
U.S. COURTHOUSE
FOLEY SQUARE, N.Y., N.Y. 10007 TELEPHONE: CORTLANDT 7-4580

MR. HAIMOFF: We will stipulate it.

MR. CRACO: Subject to check.

Q What did you do with the $357,000 when you got it?

A Deposited it in the bank account of General Investors.

MR. CRACO: I have no further questions.

MR. POLLACK: I have only one question of the witness.

THE COURT: All right.

CROSS EXAMINATION

BY MR. POLLACK:

Q Mr. Herzfeld, did Charles Allen ever make any representation of any kind to you in connection with Firestone?

A No.

MR. CRACO: Excuse me, your Honor, that is stipulated in the pretrial order, that he did not.

THE COURT: That he did not.

MR. POLLACK: Your Honor, it is not stipulated he did not make the representation. At this time, your Honor --

THE COURT: All right, to shorten it, did Allen make a representation?

THE WITNESS: I answered the qestion no, your Honor.

MR. POLLACK: At this time, your Honor, in view of the admission by the witness that Mr. Allen made no representation of any kind to him, and in view of the admission by Laventhol which is No. 2 of II in the pretrial order, and I will read it into the record, which says Charles Allen never made any representations of any kind to Laventhol in connection with Firestone, I respectfully move to dismiss the third-party claim against Charles Allen for total failure of proof of any kind against him.

THE COURT: I will hear argument on it at the close of the day.

MR. CRACO: Thank you, your Honor.

MR. POLLACK: Your Honor, I also make the same motion as to Allen & Company.

MR. BRINN: I had two or three questions, if you will just bear with me.

THE COURT: All right, I am sorry.

CROSS EXAMINATION

BY MR. BRINN:

Q Mr. Herzfeld, when you brought an action against the Firestone Group, Allen & Company, Inc., Allen, Charles Allen, Lee Meyer, Irwin Kramer, Richard Firestone, Martin

Scott, Holtzman, Wise, and Shephard, James Deer, Jacobs, Persingor, and Parker, and Laventhol, Krekstein and Horvath & Horvath, you did not sue Mr. Baird?

A No, I did not.

Q You did not make any claim against him of any nature?

A None whatever.

Q How long have you known Mr. Baird?

A Many years.

Q Do you consider him a very good friend of yours?

A Excellent.

Q And his reputation as far as you are concerned?

A The highest.

MR. BRINN: That is all.

THE COURT: Mr.Scott, do you have any questions?

MR. SCOTT: No questions.

THE COURT: All right, you are excused.

MR. HAIMOFF: No, your Honor, I have a few questions on redirect.

THE COURT: I am sorry.

MR. HAIMOFF: I thought perhaps we would do it after the recess.

THE COURT: I would like to dispose of this witness if we can and then have a short recess and then take the next one.

MR. HAIMOFF: I will do my best to be as quick as I can, your Honor. There are a few points I must cover.

REDIRECT EXAMINATION

BY MR. HAIMOFF:

Q Mr. Herzfeld, dealing with the recommendations or the high, enthusiastic recommendations about the stock which you received from Mr. Baird, in which he reported discussions he had had with other people, have you had or received glowing recommendations from time to time in your experience in making investments similar to these recommendations?

A Yes, I have.

MR. CRACO: Objection.

THE COURT: Sustained.

MR. HAIMOFF: Your Honor, I think this is relevant, if your Honor please.

THE COURT: I'm sure you did or you wouldn't have asked the question. I don't think it is.

Next question.

MR. HAIMOFF: Very well, your Honor.

Q Have you, subsequent to receiving such glowing reports, nevertheless determined to examine figures to determine whether or not the figures which you looked at would substantiate the glowing recommendations which you have received?

A Yes, I have.

MR. CRACO: Objection.

THE COURT: Sustained.

Q Now, I call your attention to Note A on Exhibit B to the note and stock purchase agreement which has been referred to, and to the fact that the statement indicates projected net income of $315,000.

When you examined that report, was it clear to you that the computation of net income at $315,000 excluded any provision for the deferred income?

A That was my understanding.

Q And what was the amount of the deferred income included in Note A before taxes?

A $2,702,000.

Q One more question on this:

What significance in your mind did you give to the word "deferred"?

A Simply that.

MR. CRACO: You mean at the time he read it?

MR. HAIMOFF: At the time. I said in his mind at the time.

His state of mind at the time is what I am asking him about.

A It simply meant to me that the profit would be picked up in a subsequent accounting period.

O I show you the Laventhol report.

THE COURT: Exhibit what?

MR. HAIMOFF: Beg your pardon?

THE COURT: Exhibit?

MR. HAIMOFF: Plaintiff's Exhibit 7.

O And particularly I show you Plaintiff's Exhibit 7-A which is the income statement.

A Yes.

O Reference has been made to the earnings per share figure included on the bottom of Plaintiff's Exhibit 7-A at 10 cents a share.

A Yes.

O I ask you to look at that page.

A Yes.

O And tell me whether or not the calculation of 10 cents per share takes into account the deferred gross profit?

A It does not.

Q In looking at Plaintiff's Exhibit 7-A, what significance did you attribute in your mind to the word "deferred"?

A I understood that this is a profit that the company had made and was going to pick up in a subsequent accounting period.

Q In making your calculations and in your conclusions as to the value of the stock, did you rely upon the provision for gross profit included in Plaintiff's Exhibit 7-A?

A Absolutely.

Q The question has been raised about your omission to read Note 4, which reference follows the reference to $1,795,000 as gross profit.

Can you give us your state of mind at the time which resulted in your omission to read Note 4?

MR. CRACO: I object.

A I have never.

MR. CRACO: Excuse me.

MR. HAIMOFF: If your Honor please, reliance is the principal issue in the case. His state of mind is the crux of the case, I believe, your Honor.

THE COURT: I don't think his subjective state of mind has a thing to do with it.

MR. HAIMOFF: There are two things involved, I

agree with your Honor.

THE COURT: To judge it by objective standards, not by what he may have been thinking subjectively.

MR. HAIMOFF: There are two aspects to that if I may be heard for just one moment.

A, his subjective state of mind, and B, as to whether or not he acted reasonably. In other words, ifhe is foolish or quixotic in the way he analyzes a statement or does not know what he is looking at of course your Honor is not bound, but sometimes preliminarily --

THE COURT: If he was foolish or careless that is no definition of fraud is it?

MR. HAIMOFF: That is another point.

THE COURT: I never thought it was. You can't cheat a fool.

MR. HAIMOFF: That is true, your Honor. But as I say, this question of reliance is a controversial question so sometimes that-- and just exactly what it means is not --

THE COURT: I can answer it for him. I know what he is going to say; but what would he say? He is suing.

MR. HAIMOFF: If you want me to tell you what I think he will say, your Honor.

THE COURT: There isn't any question what he is going to say. I will take it for what it is worth, which is

nothing.

MR. HAIMOFF: Very well, your Honor, I will withdraw the question. In view of the fact that your Honor considers it would have no value there is no need for me to press the point. I think the record is clear on the question.

THE COURT: We will take a recess.

(A recess was taken.)

MR. HAIMOFF: If your Honor please, before calling Mr. Fell, who is a certified public accountant, I would simply like to call the Court's attention, without recalling Mr. Herzfeld, to the provision or to the language in December, in the letter of December 16th, which we claim afforded the plaintiff a right of rescission based upon the results of his examination of the Laventhol report.

THE COURT: Are you referring to an exhibit in evidence?

MR. HAIMOFF: The exhibit is Plaintiff's Exhibit 9.

THE COURT: Thank you.

MR. HAIMOFF: I don't need to recall the witness, I believe.

MR. CRACO: Plaintiff's Exhibit what?

MR. HAIMOFF: It is not 9, excuse me.

MR. CRACO: Is it 6?

MR. HAIMOFF: Plaintiff's Exhibit 6, yes.

MR. HAIMOFF: All right.

Mr. Fell.

L E O N A R D H. F E L L, a witness called by the plaintiff, being first duly sworn, testified as follows:

DIRECT EXAMINATION

BY MR. HAIMOFF:

Q Mr. Fell, what is your occupation?

A I am a certified public accountant, sir.

Q Are you a member of any accounting firm?

A Yes, I am a partner in the firm of Brout & Co. with offices at 380 Madison Avenue, New York.

Q How long have you been engaged in the practice of your profession?

A I have been practicing since 1950. I was certified by the State of New York as a certified public accountant in 1954, and I have been a member -- a staff member of my firm starting with 1951, and was admitted as a partner on January 1, 1968.

Q What is your particular function in the Brout firm?

A I was what is classified as an audit partner.

Along with the other partners we service the prospective clients of the firm.

O Does your firm represent public companies?

A We don't represent. We are auditors and audit the books of both publicly and privately held companies.

O In connection with the performance of the services which you rendered for these publicly held companies, have you prepared statements, accounting statements which are included in registration statements?

A Yes, we have.

O Are you a member of any associations of accountants?

A Yes, I am a member of the American Institute of Certified Public Accountants; a member of the New York State Society of Certified Public Accountants; and I am a member of the Committee on Cooperation With Credit Grantors of the New York State Society. It's an organization that gives seminars on financial statement preparation on credit grantors such as the New York State Credit and Financial Management Association.

O Have you also lectured in accounting?

A Yes, I was a lecturer in the undergraduate courses in accounting at Queens College, which I did for approximately four years.

O Mr. Fell, I show you certain papers which have

been produced by the defendant Laventhol from their files as having been maintained in connection with the accounting services which Laventhol performed for Firestone. Have you previously examined the documents which you now hold in your hand?

A Yes, I have.

Q I show you a report of Laventhol, Plaintiff's Exhibit 7.

A Yes.

Q Have you examined that report?

A Yes, I have.

Q On the basis of your examination of the documents produced by Laventhol and your examination of Plaintiff's Exhibit 7, have you been able to arrive at a conclusion as to whether Plaintiff's Exhibit 7 reflected an examination made in accordance with generally accepted auditing standards and that the financial statements included in Plaintiff's Exhibit 7 were prepared in conformity with generally accepted accounting principles subject to the exception provided for in the report?

MR. CRACO: If your Honor please, I object only as to form and perhaps I can clear it by one question on voir dire.

THE COURT: All right.

VOIR DIRE EXAMINATION

BY MR. CRACO:

Q Referring to the papers in your hand other than Exhibit 7, are those the only papers produced by Laventhol in connection with the litigation in which you are testifying which you examined?

A No, there were many other papers which I have reviewed or have gone through. These are the only papers I felt pertinent to the matter on which I thought I would make testimony.

BY MR. HAIMOFF:

Q Is it a fact the papers you now have in your hand are the papers you picked out of the file of papers which I produced for your examination in my office?

A Yes, I selected these papers for the purpose of the examination.

Q Now, then, can you answer the question?

A Yes, after examining the papers and the report, I am of the conclusion that the financial statements were not in accordance with generally accepted accounting principles and that based upon the work papers that I did examine, including those in my hand, the audit was not performed in accordance with generally accepted auditing standards and that the firm, the accounting firm, was not permitted under our statements of working auditing procedure to render an opinion on these financial statements.

MR. CRACO: If your Honor please, I move to strike the last portion of that answer as not being responsive to the question asked.

THE COURT: Yes, strike it out.

O I will ask you specifically, then, Mr. Fell, based upon your examination of the documents which you have in your hand, whether you were able to form an opinion as to whether or not the accountants were qualified or were authorized under accepted accounting principles and approved auditing standards to render any opinion on the financial statements of Firestone?

MR. CRACO: I object.

THE COURT: Sustained. I take it the objection is as to the form?

MR. CRACO: Yes, your Honor.

O Mr. Fell, before we get to the question of the right of Laventhol to render an opinion, can you give us the factors which you took into account in arriving at your conclusion that the report was not prepared in accordance with accepted accounting principles and approved auditing standards?

A Yes.

THE COURT: Whatever those may be.

MR. HAIMOFF: He will testify to them, your Honor.

A I would give my observations principally to the transactions regarding the alleged purchase and sale of the

nursing homes, the purchase by Firestone and the sale by Firestone, and I would like to talk about that aspect of it.

What I have reviewed among the papers that I examined in the Laventhol work papers whether a purchase agreement, a contract of purchase, between Firestone and I believe Monterey Inns, I believe is the seller, and I examined what was called or labeled a contract of sale between Firestone as the seller and Continental Recreations as the purchaser, and in examining those opinions it appeared to me that the --

MR. CRACO: Excuse me. Your Honor, I hate to interrupt this witness, but I believe the question was to identify for you the standards he used in arriving at his opinion.

MR. HAIMOFF: No, what I asked him --

MR. CRACO: Excuse me, your Honor.

THE COURT: Let me have the question back.

(The question was read.)

THE COURT: Strike the answer as not responsive.

MR. HAIMOFF: I don't understand the Court's ruling.

THE COURT: You asked what the factors were to be considered and his conclusion that the statements were

not prepared in accordance with accepted accounting principles.

MR. HAIMOFF: Exactly.

THE COURT: He was testifying to what was deemed to be, if I can draw an inference, a legal opinion of a contract here.

Go ahead. See if you can answer the question.

THE WITNESS: The financial statement recorded as a completed purchase and a completed sale the nursing homes, and the papers that I examined indicated that title had not passed, that the papers said title had not passed.

THE COURT: Objection sustained.

Strike it out.

MR. HAIMOFF: If your Honor please, the documents themselves recite title had passed.

THE COURT: I can pass on it. It is a legal question whether title has passed, not an accounting question.

MR. HAIMOFF: With all due respect, if your Honor please, an accountant very often, in rendering his reports, must review documents, legal documents, and must arrive at a determination or get letal opinion.

THE COURT: That may be, but the answer isn't responsive to your question and what he just said is a pure legal question for the Court and not for an accountant.

THE WITNESS: Your Honor, I am an attorney.

I don't know if that has any bearing.

THE COURT: I don't care. I am the one who gives legal opinions here.

Q Well, Mr. Fell, is it fair to say, then, that in arriving at your conclusion on the way in which the Monterey transaction was handled, you did take into account your analysis of the Monterey contracts and the Continental Recreation contract for the purpose of determination whether or not title had passed as the contracts recited?

MR. CRACO: Objection.

Grossly leading.

Your Honor, I don't generally object to leading questions when we are dealing with an expert witness.

THE COURT: Sustained.

MR. HAIMOFF: I asked what factors he did take into account.

THE COURT: What accounting factors did you take into effect?

THE WITNESS: I took into effect, your Honor, the accounting records reflected a purchase and a sale and I raised a question in my mind as to whether or not the transaction should have been recorded, because under generally accepted accounting principles you should not record on the books of a company or reflect in its financial

statements transactions in which title has not passed, and I raised the question whether or not the title had passed in this transaction and if the title had not passed then the company should not have reflected the purchase nor the sale.

Q Let me ask you this question, Mr. Fell:

Is there any procedure which you consider an accountant ought to follow where a question is presented as to accounting treatment depending upon whether or not title has passed? What investigation, if any, or what inquiries, if any, should an accountant make under those circumstances?

A Where we believe a legal question is raised, we would go to counsel for the company or counsel for any of the interested parties and get from them a legal opinion as to what legal effect the document has and then we would expect the accounting transaction to follow the legal consequences thereof.

Q From your examination of the work papers which have been produced by Laventhol, did you find any legal opinion of company counsel or outside counsel or any attorney which Laventhol had obtained on this subject?

A No, I did not.

As a matter of fact --

MR. CRACO: Excuse me. We got the answer.

THE COURT: Don't volunteer.

O I want to call your attention to the trial balance which has been marked Plaintiff's Exhibit 16 and ask you whether you can tell me, on the basis of an examination of that record, as to whether or not the Monterey transaction had been reflected on the books of Firestone prior to the time when Laventhol commenced its audit?

MR. CRACO: I don't believe Exhibit [illegible]s been offered in evidence yet. I have no objection to it, but I think the record ought to show it.

MR. HAIMOFF: I am not quite clear whether or not the exhibits which are referred to in our pretrial order are in evidence or I have to reoffer them or what our situation is.

MR. CRACO: We discussed that this morning.

THE COURT: Offer it.

MR. HAIMOFF: I offer it in evidence.

THE COURT: Offer No. 10 in evidence.

MR. HAIMOFF: It is 16. I offer it in evidence.

THE COURT: Received.

(Plaintiff's Exhibit 16 received in evidence.)

xx

A The answer is the records do not reflect that transaction. The books of Firestone do not reflect the

Monterey transaction.

THE COURT: You mean they do not show it?

THE WITNESS: That's right.

THE COURT: I thought maybe you had to have a mirror to look at it.

Q Now, on Plaintiff's Exhibit 16, what entries were made by Laventhol to reflect the Monterey transaction, if any?

A The Laventhol work sheets indicate that they made an entry which they reflect as entry No. 24 in which they simultaneously record the purchase of the Monterey Homes by Firestone and the subsequent sale by Firestone and it reflects in this entry a profit on the sale of $2,030,500. And this entry is then recorded on the accountant's work sheet which, when added to the company's other records, reflect the figures that appear in the financial statement.

MR. CRACO: May I inquire whether the witness was reading from Exhibit 14?

MR. HAIMOFF: 16.

MR. CRACO: The trial balance?

THE WITNESS: I am reading from Exhibit 16, which reflects a transaction --

MR. CRACO: Thank you. I don't have a copy of it.

Q Now, Mr. Fell, the entries contained on

Plaintiff's Exhibit 16, do they incorporate a journal entry?

A Yes, they do. They incorporate a journal entry No. 24 which is shown here on what is called Plaintiff's Exhibit 14.

Q Now, is it fair to say, Mr. Fell, that these are the first entries which appear on the books of Laventhol or any accounting record relating to Laventhol reflecting this Monterey transaction?

MR. CRACO: Objection.

THE COURT: Sustained.

MR. CRACO: Just so the record is clear, did you intend to refer to books of Laventhol?

MR. HAIMOFF: Books of Firestone.

MR. CRACO: I make the same objection as the question would be put.

4B

Q Mr. Fell, are the entries contained on Plaintiff's Exhibit 7 with respect to the deferred gross profit the same figures which appear on the work papers towhich you have referred as part of Plaintiff's Exhibit 16?

A No, there was one intervening step. After the recording of the profit of $2,030,500, they made another entry later on on another sheet of paper -- I have another sheet here. It is marked your Plaintiff's Exhibit 18 -- in which --

MR. CRACO: Can we have it offered?

MR. HAIMOFF: I offer Plaintiff's Exhibit 18 in evidence.

MR. CRACO: May I see it, please?

THE WITNESS: The sheet is headed up --

MR. CRACO: Excuse me. No objection.

THE COURT: Received.

xx (Plaintiff's Exhibit 18 received in evidence.)

THE WITNESS: This particular sheet is headed up "Additional Adjusting Entries"and another entry is reflected where the profit of $2,030,500, as reflected on journal entry 24, is now modified by setting up as a deferred portion $1,795,500, and there is a computation showing how they arrived at that adjustment.

Q Can you give us the computation reflecting that adjustment?

A Yes. The calculation here indicates that there was a payment received by Firestone for $25,000 on November 26, an additional $25,000 was due on January 2, 1970.

Q That payment had not yet been received, is that correct?

A It was not yet received, that's correct. I am merely reading what it says on here.

And, in addition, it says that the liquidated damages would be $185,000. They take the 185,000, add it to the two $25,000 payments, come to a total of $235,000 and then they subtract this $235,000 from the previous gross profit of $2,030,500 and come up with a net figure of $1,795,500, which they now record as a reduction of the earned profit and set up as a deferred profit on the sale.

Q So that included in realized profits on the basis of this Monterey transaction is the sum of $235,000, is that correct?

MR. CRACO: Excuse me. Where does the phrase "realized profit" comes from in any of the exhibits that have been marked?

Q Can you answer that question and tell us?

MR. CRACO: I object to the question in its present form. Exhibit 7, which is the statement as to the fund, does not use that language.

THE COURT: I would think Exhibit 7 speaks for itself.

Q Let me ask you this question, Mr. Fell: Can you determine from an examination of the work papers that you have referred to and Plaintiff's Exhibit 7 whether or not the sum of $235,000 attributable to the Monterey transaction was included in the net income -- not the deferred net income but the net income -- of Firestone as reflected on Plaintiff's Exhibit 7-A?

A Yes. It is reflected because the work papers indicate that the company took the selling price of $15,393,000, which it included in its sales, less the $13,362,500, which it included in its cost of sales, subtracted one figure from the other, reported at first the grossprofit of $2,030,500, and then deducted from this what is referred to as the deferred income of 1,795,500, so that the income as reflected in the income statement includes the balance of $235,000 by pure subtraction.

Q So that is it fair to say, Mr. Fell, that the Monterey transaction is included in sales as approximately

a $15,000,000 sale out of the total sales reflected on Plaintiff's Exhibit 7 of 22,000,000 and at the same time the net income reflects a payment or a sum due as liquidated damages from the purchaser which would become payable in the event the transaction was not consummated?

MR. CRACO: I object to the form of the question.

THE COURT: In what respect?

MR. CRACO: It's leading, your Honor.

THE COURT: Yes.

MR. CRACO: It has no basis established for it in any of the evidence that has been adduced up to this point.

THE COURT: Yes, sustained.

Q Let me ask you this question: can you tell from the documents and records which you have in your hand whether or not the Monterey transaction was included in sales?

A Yes. The sales of $15,000,000 is included in the total sales of $22,000,000 as reflected in the income statement of Firestone.

Q Can you determine from the records and papers which you have in your hand whether the sum of $185,000 was included in Firestone's net income?

A Yes, it was.

Q And that sum being the sum which would become due in the event that the sale was never made?

MR. CRACO: I object to the question.

THE COURT: Sustained. What was that sum?

Q What was the sum of $185,000?

A The $185,000 of income is the calculation that I just referred to in which the auditors reduced the gross profit of 2,030,000 by the sum of 1,795,000, thus leaving in the income statement $235,000, which they refer to in their work sheet as the $185,000 of liquidating damages, plus the $25,000 already received and the $25,000 to be received.

MR. CRACO: May we have the work sheet referred to proffered?

THE COURT: Yes.

THE WITNESS: The work sheet I am referring to now is Plaintiff's Exhibit 18 in which they reflect the fact that they are deducting from the gross profit of $2,030,000 the sum of $1,795,500, leaving 235,000 in the income and breaking the 235,000 down into three parts: the $25,000 received prior to November 30, the $25,000 due on January 2, 1970, and the $185,000 of liquidating damages that would be due in the event that the transaction

was never consummated.

MR. HAIMOFF: Do you want to see it?

MR. CRACO: Is that in evidence?

MR. HAIMOFF: Yes, it is.

For the sake of continuity --

THE COURT: I understand it. I understand that they reflect both the sale, a consummated transaction, and liquidated damages in the event the transaction collapsed.

THE WITNESS: Yes, sir.

THE COURT: Inconsistent?

THE WITNESS: Yes, sir.

Q I would like to now ask this question: can you determine what the net income of Firestone would have looked like had the liquidated damages been omitted from the statement of income?

A Are you talking about the liquidated $185,000 or the $235,000?

Q Either one. One at a time.

A If the $235,000 of income that was included in this statement were omitted, then instead of showing a profit before taxes of $104,000 it would have shown a loss of $130,000 before taxes.

Q And is it also true, Mr. Fell, that if the

$185,000 were omitted, the income statement would show a deficit? Isn't that true?

A That is correct.

Q Now, Mr. Foll, can you tell me whether or not in your opinion upon an examination of Note 4 to the income statement, whether that note properly explains the Monterey transaction?

MR. CRACO: If your Honor please, I object to that. I object to it for the fundamental reason that the proof up to this point is unequivocal that Note 4 was never referred to by the plaintiff in this case and it seems to me that the absence of reliance which has been demonstrated by his testimony on both direct and cross can't be skirted by getting an accountant to come in here and using 20/20 hindsight and explaining what he thinks it says.

In the state of the proof you have before you, the opinion that is being elicited is absolutely immaterial.

MR. HAIMOFF: If your Honor please, we do not dispute that plaintiff did not look at Note 4. What I wish to show by this witness is that even an examination of Note 4 does not properly reflect what had actually occurred in connection with the Monterey transaction.

SOUTHERN DISTRICT COURT REPORTERS
UNITED STATES COURT HOUSE
FOLEY SQUARE, N.Y., N.Y. 10007 TELEPHONE: CORTLANDT 7-4580

THE COURT: All right, for that limited purpose.

A In reading Note 4, it recites the fact that the company had purchased, using the past tense, and it refers to the fact that it had sold, again using the past tense, the property involved.

Q Are we again dealing with the same legal question that you referred to before?

MR. CRACO: I object to the form of the question.

THE COURT: Yes.

Q In the course of proper accounting practice as you know it, could you arrive at accounting treatment of a transaction which depended upon the interpretation of an agreement as to what its legal effect was without obtaining an opinion of counsel?

A Yes.. There is a book which I happen to have with me called The Dictionary of Accountants By Kohler, which is a leading authority on accounting definitions, and in there they refer -- I can either read it or I can editorialize what it says.

It says that an executory contract or commitment is not recorded on the books but a transaction is only recorded after the title -- after the transaction has been completed. And in my reading all of the documents I have

scan, it was improper to reflect this transaction and these financial statements and, therefore, on the records.

MR. HAIMOFF: I have no further questions.

MR. CRACO: May I have just a moment?

THE COURT: Yes.

(Pause.)

CROSS EXAMINATION

BY MR. CRACO:

Q I wonder if you would be good enough to cite us chapter and verse.

THE COURT: I have one question.

You said it would be improper to show an executory contract on the records. What records?

THE WITNESS: The financial records of the company.

THE COURT: As distinct from the books?

THE WITNESS: No, the books. When I say the financial records, I am referring to the books, the financial statement, everything.

3 THE COURT: Was this executory contract shown on the books, on the underlying books?

THE WITNESS: It was shown on the books only after Lavanthol made the entry you referred to before. The accountants made an adjusting entry to the books adjust-

ing the books to reflect this transaction and then gave effect to this transaction on the books and financial statements as though it had been put on the books initially.

BY MR. CRACO:

Q Lets take that first.

Is there anything unusual about adjusting entries?

A Not when properly recorded.

Q So is it not the fact that as a matter of ordinary course when an audit is done adjusting entries to reflect any number of kinds of transactions that have not yet been posted on the books are suggested by the auditors and placed on the books of the company after the termination of the audit?

A No, that's not so, sir.

Q It is not?

A It is normal for accountants to make adjusting entries which are to correct or further clarify entries recorded by the company, correcting entries, so to speak, but as far as recording transactions that are not recorded at all, since the financial statements and the books are the property of the company, it is incumbent upon the accountant, if they think an entry should be made to correct the books, they ask for a representation in writing from

the management saying, "Please correct my books because I omitted to record the following."

So that while all entries are called adjusting entries, there are really two types, one to correct what has already been recorded and the other is to update for transactions that may have not been recorded at the time the auditors came in.

Q And there is such a thing as the second?

A Yes, if the management gives you what is called a letter of representation telling you to do it, and I have been unable to find that in the work papers I have examined.

Q Now, you said that you found no entry relating to the Montezoy transaction in the Laventhol papers other than the adjusting entries, is that true?

A Yes.

Q Didn't you find entry No. 24?

A No, that's not on the books. That is an entry of Laventhol. The question that was asked to me was, I believe, did I find an entry on the books of Firestone.

T5

Q Did you look at the books of Firestone?

A I looked at the trial balance of Firestone which --

Q Did you look at the books of Firestone?

MR. HAIMOFF: May he finish, Mr. Craco, please? You looked at the books of Firestone?

THE WITNESS: I looked at the books of -- the balances on the books of Firestone as reflected in the Laventhol work sheets which indicated the open balances on the books of Firestone before the arrival of the Laventhol auditors. I then saw that the entire --

MR. CRACO: Excuse me. I want an answer to my question.

MR. HAIMOFF: May he finish?

THE COURT: Answer the question.

THE WITNESS: Have I seen the books?

Q Of Firestone.

A I have not seen the books of Firestone.

THE COURT: Never?

THE WITNESS: Never.

THE COURT: So you don't know what is on them?

THE WITNESS: Well, I do know, sir, if I could --

THE COURT: You don't have any personal knowledge?

THE WITNESS: I do, sir, because I have seen by the entry recorded by Laventhol that the entire transaction has been reported by Laventhol and therefore it can't be on the books if it's recorded by Laventhol. You may call it indirect, but it's obvious to me as an auditor that it can't be on there if the accountants --

Q Let me ask you this: Was the $25,000 that had been received recorded on the books of Firestone as reflected by the work papers of Laventhol?

A No, it was not on the books of Firestone.

Q It was not?

A No, sir.

Q Is there an entry on the trial balance or the adjusting entries referred to as exchange in the amount of $25,000?

A Yes, there is.

Q Would you explain what that entry is?

A Yes. What happened was, it appears from the accountant's work papers on that on November 26, 1969, a $25,000 deposit was made into the bank account of Firestone, but that transaction had never been entered on the books of the company. When the auditors discovered this, they made an entry recording the receipt of cash, and for the moment, not knowing what it applied to, they

set up an account called "Exchange" for $25,000.

Q On what document does that figure appear?

A That document appears in the Laventhol journal entry which I have here.

Q What is the exhibit number?

A On Plaintiff's Exhibit No. 14, the same sheet that records the original transaction, the entry below the -- journal entry No. 25 refers, as an entry, which is known as debit cash and credit exchange, which says to record and deposit on November 26, 1969, for $25,000.

Q Do you know what Exhibit 14 purports to be?

A Yes.

Q What is it?

A It represents adjusting journal entries prepared by and submitted by the Laventhol auditors.

Q Where did they get the information on it?

A I would assume they got it through the audit and inspection of the records of Firestone and in meetings with and inquiries made of the Firestone personnel.

Q So there was some record in Firestone of the receipt of the $25,000?

A No, sir, they found that -- the only way they found this is when they looked at the bank statement, which is a statement of the bank, and compared it to the books of

the company and didn't find it recorded on the books of the company.

Q How do you know allthat happened?

A Because there -- on this entry they are first recording it, which means it could not have been recorded before this entry gives effect to it.

Q So you say except for the bank statements there was no evidence of that transaction?

A Well, they could have been told. They may have been told by somebody that it has not been recorded, but it was not on the books.

Q But for the moment your definition of books does not include the current bank statement of Firestone; is that right?

A Excuse me, Firestone doesn't have a bank statement. The bank statement is sent in by the bank which is reconciled to the books of the company.

Q You are excluding that from Firestone's books?

A Well, by incorporation every entry that is made by an accountant ultimately finds its place on to the books. I believe the question that was asked of me was the books of the company prior to the entries recommended by Lavanthol.

Q I am not trying to be cute with you. When you

SOUTHERN DISTRICT COURT REPORTERS
U.S. COURTHOUSE
FOLEY SQUARE, N.Y., N.Y. 10007 TELEPHONE: CORTLANDT 7-4580

answered that question to the effect that the books did not display this transaction, you did not mean to refer to the then current bank statement of the Firestone Group; is that right?

MR. HAIMOFF: I object to that question, if your Honor pleases. When Mr. Craco refers to this transaction, is he referring to the Monterey transaction, or is he referring to a $25,000 cash deposit which nobody knows what it related to until they asked questions and made further inquiries?

MR. CRACO: That is the business of an auditor to do that, isn't it?

MR. HAIMOFF: The point is -- I don't know if we want to argue it now or not -- the point is that it's a $25,000 cash deposit. It doesn't mean anything.

THE COURT: Overruled.

MR. CRACO: May I have the question reread to the witness?

(The pending question was read.)

A The books -- I will have to stand --

THE COURT: Answer it yes or no.

THE WITNESS: It can't be, sir. The question is inconsistent. I am not trying to argue with anybody, but --

THE COURT: All right, if you can't.

A The books do not reflect the $25,000. I must reiterate that.

Q But the bank statement does?

A The bank statement does. The bank statement submitted by the bank does so.

Q And an auditor, in the course of his audit, when he gets a bank statement that reflects such a deposit, will inquire as to the nature of the deposit and the reason for the deposit and what have you; is that right?

A That is correct.

Q And it is your testimony, I take it, that Exhibit 14 and the entries on it about the Monterey transaction reflect that Laventhol having discovered that deposit in the bank statement made certain inquiries about the nature of the transaction which had generated that deposit; is that fair to say?

A That's an assumption that could be made.

Q Is that the assumption that you made in rendering your opinion here?

A No, I would not, because I find that the transaction first recording the purchase and sale is made, and later the entry recording the undiscovered $25,000 deposit shows up later as a later entry, and I am assuming these

entries were prepared as they were discovered, but that is an assumption.

Q That is an assumption?

A That's correct.

Q You have no basis other than the sequence of events on that page that you selected from others; is that correct?

A That is correct.

Q Let's start at the end if we may. Look at Exhibit 7 in evidence.

A Yes, sir.

Q Can you tell the Court whether anyone reading that or any similar report of a Certified Public Accountant on a set of financial statements may properly take a single line out of the entire report and draw conclusions about the financial condition of the company from that single line?

MR. HAIMOFF: I object to that, if your Honor please, as entirely too general. It seems to me we are entitled to have specific questions asked about specific entries and exactly what people are entitled to. Laymen now. We are not talking about accountants any more, but laymen, and I don't know why this witness should be called upon to give his opinion as to what conclusion laymen are

entitled to come to from reading an accountant's report.

MR. POLLACK: Objection to the form of the question.

THE COURT: Can I have the question, please?

(The first portion of the pending question was read.)

THE COURT: Sustained.

Q I draw your attention to the opinion on page 1 of Exhibit 7. Do you see it?

A Yes.

Q Have you had occasion from time to time to render opinions on behalf of the firm that you are a member of?

A Yes.

Q Have those opinions recited that the examination was in accordance with generally accepted auditing standards and so forth?

A Yes, it has.

Q Like Exhibit 7?

A Yes.

Q Have you rendered opinions like the one in the last paragraph with or without qualifications?

A Yes, we have.

Q And you have opined from time to time, have you

not, for the benefit of whoever might read the opinion, that the accompanying consolidated balance sheets and related consolidated statement of income and retained earnings present fairly the financial position of blank corporation as at a certain date; is that right?

A Are you asking me in general or this one?

Q You have rendered such opinions, have you not?

A Yes, I have.

Q And you recite, do you not, in those opinions that this consolidated statement fairly reflects the financial position of the company in conformity with generally accepted accounting principles; is that right?

A Yes.

Q When you render such an opinion, to whomever you render such an opinion, do you intend the opinion to refer to the financial statements to which it is appended taken as a whole?

MR. HAIMOFF: I object to that, if your Honor please. We are not dealing with financial statements taken as a whole.

MR. CRACO: We sure are, and that is my problem.

MR. POLLACK: Further objection on the grounds that his intention in financial statements other than this one is quite irrelevant.

THE COURT: Overruled. I will take it bearing on what the term means.

A When we render an opinion, we refer -- under normal circumstances we would refer to the financial statements and all parts thereof.

Q Taken as a whole?

A That is correct.

Q Is one of the parts which is included in that whole the notes to the financials?

A Yes.

Q In your opinion and experiance, are the notes to the financial statements an integral part of the financial statements upon which an opinion is rendered?

MR. HAIMOFF: I object to that as immaterial, if your Honor please. I do not dispute the correctness of Mr. Craco's statement.

MR. CRACO: I would like the witness --

MR. HAIMOFF: That is, that notes are an integral part of the financial statements of which they are a part.

THE COURT: I think he is entitled to an answer from your expert.

Q Do you agree with that?

A Yes, I agree with that.

Q Therefore, when the correctness or incorrectness of the opinion is being discussed, the opinion rendered by the accountant, the financial statements taken as a whole, including the notes, have to be considered, do they not?

A Yes.

Q Because that is the thing to which the opinion runs, right?

A The thing -- there is no one thing. It's the whole package as a package.

Q That's right, all right. Are you familiar with the auditing standards and procedures, statements on auditing procedure No. 33?

A Yes, I have a copy of it here, yes.

Q Are you familiar with the chapter on adequacy of informative disclosure?

A Are you referring to the S.A.P. 33 issued in 1963 or the updated one of 1972? There are two versions known as the gray volume and known as the blue and gold volume.

Q I am not sure which one I am reading from, although I have both of them here. I think I am reading from 1963.

A All right, I just want to be consistent with

you. Go ahead.

Q The 1963 version was the one that was in effect at the time of the audit involved when this case took place, is it not?

A Yes.

Q Are you familiar with the chapter on adequacy of informative disclosure that is in that edition?

A Yes, I am.

Q Do you have it in front of you?

A If you will give me -- I don't know the book by heart -- if you will refer me to page and verse, I would like to refresh my recollection.

Q I am referring to pages 54 and 55 of Chapter 9.

A Yes. I have it here.

Q I direct your attention to numbered Item 3 of that chapter and ask you to read it to the Court, and then I want to ask you a couple of questions about it.

A "Verbosity should not mistaken for adequate disclosure. What constitutes a matter requiring disclosure is for the independent auditor to decide in the exercise of his judgment in the light of the circumstances and facts of which he is aware at that time. That later events may give greater importance to matters which at the time appeared to be of minor consequence does not of itself impugn the

soundness of his judgment. Foresight and hindsight cannot be admitted to be of equal weight in passing upon conclusions reached at the earlier time. Hindsight should be eliminated from the factors by which the soundness of past conclusions are judged."

Q Do you take that to be a definitive and accurate statement of the standards which it recites?

MR. HAIMOFF: I object to that, if your Honor please. He reads one paragraph from a 70 or 80-page book.

MR. CRACO: He can say no if that is his answer.

MR. HAIMOFF: All of which deals with the same subject.

THE COURT: I heard what he read. What is the basis of your objection, legal basis?

MR. HAIMOFF: It's incomplete, your Honor, and it's immaterial. The question and answer are immaterial.

THE COURT: Overruled.

Q Would you answer the question?

A I believe that it's a proper statement.

Q Would you be up here making the same criticism of this treatment of the sale if in fact all the trans

actions reflected by the contracts had gone through in accordance with their terms?

A Yes, sir, I'd be making the same objections because the amount of this transaction was so -- I would like to quote from the same book that you quoted me, sir, if I may.

Q You just answer my questions.

MR. HAIMOFF: May he be permitted to quote from other sections of the same book?

THE COURT: Let him answer the question.

MR. CRACO: I am sure he can get a chance to quote on redirect anything he wants.

THE WITNESS: The nature of the transaction involved in this particular transaction involved such a material amount that in the same S.A.P. 33, if I may refer to it, it said that because -- I'd like to read it to you, sir. I am quoting from the same section. It says that, "When a qualification" --

Q May I now have the page?

A It's the same section.

Q You are now referring, are you not --

THE COURT: Can't we go here five minutes without an interruption? How in the world do you expect me to get this.

A I will give you the page number. I have a cross reference.

THE COURT: Please don't interrupt any further. Let me get this witness's answer. Then you can ask him what page.

THE WITNESS: Yes, page 58, paragraph 9, in your text.

THE COURT: Read it.

THE WITNESS: Thank you, sir. It says that, "When a qualification is so material as to negative an expression of opinion as to the fairness of the financial statements as a whole, either a disclaimer of opinion or an adverse opinion is required."

I submit to you that in this particular situation that we are referring to, the nature of this transaction was so material that hindsight or foresight doesn't alter the facts that at no time under our bible, if I may use that phrase, are we permitted to give an opinion where such a material defect is involved, and therefore, in answer to your question, I wouldn't change my opinion if the transaction had gone through afterwards. The fact was at that time it was improper to do so.

Q Let's examine that question. First of all, let me ask you whether you looked at the January, 1970, audit

that Laventhol did of Firestone.

A No, I have not.

Q Do you know whether in fact that had been produced in connection with this litigation?

A No, I do not.

Q Do you know whether in the audit work papers for January, 1970, there is a trial balance which fully reflects the transactions which you are testifying about?

A I do not know it, but I had --

Q You don't know; is that right?

A Well, may I tell you why I wouldn't know?

Q You just tell me whether you do know.

A I do not know.

MR. CRACO: Mr. Haimoff, may I have the contracts?

MR. HAIMOFF: The witness has one.

THE WITNESS: Which one?

MR. CRACO: Both.

THE WITNESS: Here you are.

(Papers handed to Mr. Craco.)

Q I would appreciate it now if you would do what you offered to do a few moments ago and find the precise place in the dictionary -- what is it called?

A A Dictionary For Accountants By Kohler.

Q I would appreciate it if you would find what

you offered to find a few minutes ago.

A May I read it to you?

Q I would appreciate your showing it to me.

(The witness handed a book to Mr. Craco.)

Q You have drawn my attention to two entries, one of which is a certain portion of the definition of "Transaction." I would like you to read to the Court at pages 430 and 431 of this dictionary the language which you have underlined and the language which follows it. That is the definition, is it not, of "Transaction"; is that right?

A Well, under the word "transaction," it says, "An event or condition the recognition of which gives rise to an entry in accounting records," and then further goes on to say, "The moment for recording a transaction is dependent on the occurrence of the event or the existence of the condition. The customary timing of its recognition" -- that is the part I have underlined.

Q Now keep going.

A Okay, "The customary timing of its recognition, ascertainment of the money amounts involved, a determination of the accounts effected, and an administrative review of the adequacy of referable supporting data

serving as objective evidence of its component elements. For the bulk of transactions, these decisions conforming to general business policy, traditional trade customs, and local conventions, are a vital part of the daily routine on which the mechanics of accounting are dependent."

Q Is it not fair to say that, according to the definition which you yourself have pulled out, general business custom and local conventions play a part in determining whether or not a transaction has occurred sufficient to give rise to an entry in the accounting records of the company and on the financial statements of the company?

A That should be given consideration, but in connection with every other component.

Q The answer is yes?

A It's an element of the judgment.

Q All right. In your judgment did you give any weight at all to local convention and business ccustom with respect to whether a transaction had occurred?

A Well, I read the document, and it said that title had not passed, and that's the only way I could come to a layman's conclusion that the transaction had not been completed, because if I --

SOUTHERN DISTRICT COURT REPORTERS
UNITED STATES COURT HOUSE
FOLEY SQUARE, N.Y., N.Y. 10007 TELEPHONE: CORTLANDT 7-4580

Q You are not presented here as a layman. You are presented here as an expert witness. I would like an answer to my question. May it be read?

A As an expert --

MR. CRACO: Excuse me. May it be read back?

(The pending question was read.)

A Yes, I gave weight to it.

Q What local convention did you give weight to?

MR. HAIMOFF: I object to this. I have been listening to it, if your Honor please. There has been no evidence of any local conventions that I know about.

THE COURT: It's in the definition.

MR. HAIMOFF: It may be a general -- there may sometimes in some cases be local conventions which can transform options into completed transactions. I know of no such conventions. There has been no evidence of any.

THE COURT: Overruled.

A I think I can answer the question.

Q I would be glad to hear it.

A I did give weight to it.

THE COURT: Please don't prompt the witness. It doesn't help.

MR. HAIMOFF: I don't intend to, your Honor.

THE COURT: That is what you are doing.

MR. HAIMOFF: I am sorry. Then I apologize.

THE COURT: I wasn't born yesterday.

MR. HAIMOFF: I didn't intend to.

MR. CRACO: I wonder if, before the witness answers, I may have the question reread, because as I hear the beginning of his answer, it is about to be unresponsive. Would you read the question back, please?

(The pending question was reread.)

A I answered that question. Your next question was what weight did I give it, and what did I do.

Q No, I said what convention did you give weight to.

A I gave weight to -- I said I would have to ask myself what is the local convention, and I said I would --

Q Did you ask that?

A Yes, I asked myself what is the -- and I as a -- not being a lawyer or practicing attorney wouldn't know, so I said I would ask the attorney to tell me what is the legal effect of this in California, and I went to the work papers of -- that were submitted by Laventhol to see if they had anywheres in their papers done what I think I would have done.

I was trying to put myself in their place, and

I could find nothing in their work papers that indicated that they had raised that question and that --

Q If in fact they had raised that question, and it were not reflected by the work papers, would your opinion about this whole thing be different?

A No, it would not be, because under the same S.A.P. 33 that you were referring to, it says that the work papers, if I can read it, "must contain sufficient evidential matter to show on what basis the accountants came to their conclusion." I could read it to you.

Q Yes, you could, but --

MR. HAIMOFF: Excuse me, I think this is important, your Honor. May I have that section of the S.A.P. read, your Honor, as part of this?

THE COURT: You will have your opportunity on redirect, counsel.

Q May I ask if you are referring to the 1963 or 1972 edition?

A It happens to be quoted verbatim in both of them, so I have it in both versions.

Q That is a matter of auditing housekeeping, isn't it?

A No, it's a matter of auditing standards, we like to refer to it as.

SOUTHERN DISTRICT COURT REPORTERS
UNITED STATES COURT HOUSE

Q But in terms of determining whether a transaction had occurred, you say that you would have put yourself in the shoes of Laventhol, and once there you would have asked for an opinion of local counsel as to the effect of these documents; is that right?

A That is correct.

Q My question is, suppose for the moment, and subject to connection, that in fact an opinion had been solicited. Would that change your opinion with respect to the transaction?

A It depends on the opinion given to me by counsel.

Q All right. We got into this discussion of legal opinions by way of my asking you what local conventions, as referred to in your own definition, you gave weight to, and I don't know that you told me what local conventions if any you gave weight to.

A The first thing to say is I would have to find out what the local conventions are.

Q Did you?

A Did I? No, I did not.

Q All right. So you have come to this court opining on the adequacies of this report without any knowledge of what local conventions if any affected the auditors when they made their report; is that right?

A Yes.

Q Does your company, your accounting company, have an office in California?

A Yes, we do.

Q Did you consult with that office in the course of preparing your testimony here?

A Yes, I did.

Q Did you consult with them about the adequacies of these contracts to effect a transaction in the definitional sense?

A Yes, I did.

Q With whom did you consult?

A I spoke to my west coast partner.

Q Who?

A His name is Victor Hollander.

Q Is it your testimony that part of what you have recited as your testimony in fact came from Victor Hollander?

A No, it is not.

Q Is Victor Hollander a lawyer?

A Pardon me?

Q Is Victor Hollander a lawyer?

A No, he is not, not to my knowledge.

Q What other local conventions if any did you give weight to in appraising the work that Laventhol had done?

A I merely read the document that was executed in California, and I saw the phrase in there that title has not passed and I say I know of nothing to indicate in this dictionary of accountants it says you should not give effect -- you didn't let me read the paragraph I wanted to read, you asked me to read the paragraph you wanted me to read.

The other paragraph says that you shouldn't record it unless title has passed, and I say that unless there is a contrary local custom that says you can record title -- you should record a transaction when title hasn't passed, I would say I would have no reason to record that transaction.

Q My question is, do you know whether there was in fact such a local convention?

A No, I do not.

Q In connection with the paragraph that you wanted to quote, would you go ahead and take your head and quote it?

A Yes.

Q First of all, give us the reference.

A This is the dictionary and under [illegible]rd commitment

the following appears.

O The page please?

A It is page 92 of the Dictionary For Accountants, and commitment is defined as, "An anticipated expenditure evidenced by a contract or a purchase order given to an outsider. Commitments are not given expression on accounting records, except sometimes on those of government agencies, since the signing of a contract or issuance of a purchase order does not give rise to a transaction. Disclosure of the amount and nature of a commitment in a balance sheet or balance sheet footnote is, however, generally regarded as required where substantial additions to capital assets are involved or the amounts of prospective goods or services contracted for is substantially in excess of a 60 or 90 day supply."

The rest is unrelated to this and --

O All right, now would you say in the terms of that definition, that the acquisition of some 15 million dollars worth of land would -- let's see,where is that language?

THE COURT: Substantial asset.

O -- would constitute the acquisition of a substantial asset having a duration of more than 60 to 90 days?

A Yes, but it should reflect -- this says --

Q Would you not say that the sale --

MR. HAIMOFF: May he be permitted to answer, your Honor?

MR. CRACO: He answered.

A No, you cut me off. It says it should be recorded as a footnote but should not be recorded on the accounting records, and I submit that if they had merely made a note about this transaction but had not given effect to it in the income statement or the balance sheet, but merely referred to it as something that is coming ahead, that is executory, if I may use that phrase.

It would have been proper to disclose it, but not to give effect to it in the financial statements other than in the note as an executory or commitment.

Q So let's nail that down.

Is it your testimony that local conventions for the moment being disregarded, it would have been misleading not to have disclosed these two contracts in some form in the financial statements of Firestone as at November 30, 1969?

And I'd like an answer yes or no to that question.

A Your Honor, he is asking me if I still hit my wife.

You are asking me, which of two --

Q I am not interested in whether you still hit your

wife and I wouldn't like --

THE COURT: Would it be misleading not to refer to them at all?

THE WITNESS: It should be referred to some place but what I read to you says it should be in the footnotes only, not in the financial statements; so I can't answer that yes or no.

Q My precise question is whether non-disclosure of these two contracts would have been misleading in your opinion under the various authorities that you are having recourse to.

A No, it would not be because in this particular transaction that you are referring to since the company stands to show a potential profit, the omission of a note about a potential profit in the future does not hurt by its omission as much as a disclosure that the subsequent transaction would materially adversely affect the financial position, so that the omission of it completely would not be as dangerous as it would be if it was an adverse effect afterward.

Q That depends on whether you are testifying for a buyer or a seller, doesn't it?

A No, I testify as an auditor, what his judgment is. I just express my own judgment.

Q Isn't it a fact that when an event occurs relating to the purchase or sale of property, the key thing governing the disclosure of that event and its accounting treatment is its economic effect?

A Yes, I would say that is true.

Q Not its legal consequences but its economic effect?

A That is correct.

But we like to think it follows the legal concepts as well.

Q Well, you like to think that.

A Our profession requires it of us.

Q Does it?

A Yes, it does.

Q Would you cite me the chapter and verse on that?

A Well, I can sit and read you -- do you have another book there? It just so happens I have another book which is 38 pages long which describes all the generally accepted accounting principles. I can't summarize it in two sentences.

Q You find me a generally accepted accounting principle that says that a transaction cannot be reflected until it is consummated as a legal event notwithstanding its economic impact on the financial affairs of the company.

A Your Honor, without going into every page here,

there are certain principles that we as accountants know for everything which says you don't record an asset unless you have legal title to it and you don't record a liability unless you have a legal obligation to pay it and the ensuing results that occur as a result of that are there, and it should be in accordance with generally accepted accounting principles and any time you record an asset that you don't know or omit a liability that do -- you are not in accordance with generally accepted accounting principles. I just don't know how to pin down that the omission of a particular item is called for or not called for.

Q I show you Exhibit 12.

Do you know whether that is a contract?

A Well, it says agreement for sale of real estate.

If agreement and contract are synonymous I would assume it is a contract for real estate.

MR. POLLACK: Objection to what the witness assumes, your Honor.

MR. CRACO: It is valuable for the basis of his opinion and nothing else.

MR. POLLACK: The document speaks for itself.

THE COURT: Yes.

MR. CRACO: I am sorry.

THE COURT: The document speaks for itself.

Q Is this such an agreement as in your opinion to create an event which requires some sort of recognition in the financial document of Firestone?

A Could you repeat that question? I am sorry.

(Ouestion was read.)

A Yes.

Q I show you Exhibit 13 and ask you the same question with respect to that.

A Yes.

Q Those together are the contract for the purchase and sale of the Monterey Nursing Home properties,are they not?

A Yes.

Q Now I refer you to footnote 4.

THE COURT: Do you expect to be much longer with this witness?

MR. CRACO: Well, your Honor, I am frank to say that I think I shall be.

THE CCURT: All right.

We will adjourn until tomorrow morning at 10:00 o'clock.

I want to hear briefly Mr. Pollack's motion. What is your answer to his motion?

MR. CRACO: Let me see if I recognize the motion to

which I am addressing myself.

THE COURT: The motion was no representations were made by Allen either to the plaintiff or to the accountants.

MR. CRACO: That is true directly.

THE COURT: You say there is an indirect representation?

MR. CRACO: As far as Charles Allen is concerned there is the testimony of Mr. Herzfeld that both Mr. Baird and Mr. Kramer told him what Mr. Allen had said, and as to Mr. Kramer, we have a person in the relationship of partnership and in-lawship.

On that question I have indicated that I do not rely on Herzfeld's testimony to impute the fact to Mr. Charles Allen that he told Baird such and such, but I do as to Mr. Kramer who was acting in concert with him in Allen & Company, Inc.

THE COURT: Let me stay with you a minute.

You say that you are not relying on the fact that Laventhol had no information from Baird?

MR. CRACO: No.

THE COURT: So as to that, that line, you are cut off? Right?

MR. CRACO: Right.

THE COURT: But you say that Kramer, his knowledge

is imputed to --

MR. CRACO: Let me take this in two bits if I can.

THE COURT: All right.

MR. CRACO: First of all, as to Allen & Co., not Allen & Co., Inc. --

THE COURT: He didn't make it as to Allen.

MR. POLLACK: My first motion is as to Charles Allen. My second is as to Allen & Co.

MR. CRACO: Let me see if I can deal with the one I can agree with.

THE COURT: Let's take the Charles Allen.

MR. CRACO: That is not the one I can agree with fast. I think I have no objection to the motion as it is addressed to Allen & Co. based upon my understanding of what Allen & Co. is.

I understand it to be a private investing --

THE COURT: All right, motion granted as to Allen & Co.

MR. CRACO: As to Charles Allen, I think it is premature for the motion to be --

THE COURT: That is what I want to find out. Why?

MR. CRACO: Because your Honor, this is a motion

to dismiss a third-party complaint against Charles Allen before I put in my case.

THE COURT: Yes?

MR. CRACO: And I am going to put in testimony that will involve Allen & Company, Inc. and I believe by imputation Charles Allen.

THE COURT: What is your answer to that?

MR. POLLACK: Your Honor, Mr. Craco has stipulated in the pretrial order, "Charles Allen never made any representations of any kind to Laventhol in connection with Firestone."

Mr. Herzfeld --

MR. CRACO: And I stand by that.

THE COURT: You stand by that?

MR. POLLACK: Let me finish, please.

Herzfeld testified Charles Allen never made any representation of any kind to Herzfeld in connection with Firestone.

THE COURT: I know that.

MR. POLLACK: Therefore Charles Allen personally was never involved in any respect in this transaction.

THE COURT: But he could be indirectly, could he not? Isn't that the point?

MR. POLLACK: No because the Allen & Co., Inc.

SOUTHERN DISTRICT COURT REPORTERS
UNITED STATES COURT HOUSE
FOLEY SQUARE N.Y. N.Y. 10007 TELEPHONE: (212) TL4-4580

is the one that was involved in the private placement. Charles Allen personally was not involved in any way, shape or form in this transaction.

MR. CRACO: No, your Honor.

MR. POLLACK: I believe that this was strictly an in terrorem thing. They sued everybody. I think we ought to limit it to the direct defendants.

MR. CRACO: I have done a lot of limiting today Judge and I have no compunction about limiting it more if it were proper to do so, but I think if Charles Allen was out touting the stock through Baird or through Kramer, I am --

THE COURT: You mean if he is tipping?

MR. CRACO: If he is tipping and other people are relying on tipping I am entitled to keep him in.

THE COURT: How are you entitled to keep him in, under an indemnity theory?

MR. CRACO: Yes, and under a contribution.

THE COURT: I think it is premature. I will deny it as to Charles Allen at this time.

What is your problem?

MR. BRINN: I want to make the same motion as to David Baird. There is no relationship of any nature between the Laventhol firm and Mr. Baird in any complaint they could have against Mr. Baird. He was not a defendant in the

original action. He was brought in just now as they brought in everybody.

Baird had no relationship to Laventhol unless you can say in any way he had at this point --

THE COURT: How do you hold Baird?

MR. CRACO: I no longer hold Baird. I consent to discontinue.

THE COURT: All right, dismissed as against Baird. How do you hold our friend who came all the way from California?

MR. CRACO: Your Honor, I hold him on a specific event which I, if I am put to my proof on the third party complaint, I will certainly show.

THE COURT: All right, premature as to him.

MR. POLLACK: Your Honor, for the clarity of the record I would like it now to reflect that the only third-party defendants left in the case definitively brought by Laventhol against them are Allen & Co., Inc., Charles Allen, Irwin H. Kramer, Martin A. Scott; and that the following third-party defendants are no longer in the defensive third-party action.

The Firestone Group Ltd., Allen & Company, Lee W. Meyer, Richard M. Firestone, and David Baird.

THE COURT: The action is dismissed as to those

latter third-party defendants.

MR. POLLACK: Thank you, your Honor.

MR. CRACO: As to certain of them, your Honor, it is dismissed because of lack of present personal jurisdiction of the Court.

THE COURT: Yes, either as to lack of jurisdiction or as to no basis, insufficiency in the evidence.

MR. CRACO: I think it is different things as to different people. Firestone, I think.

THE COURT: I think the record is clear who got out for lack of in personam.

MR. CRACO: I don't want it to be muddied by the last one.

THE COURT: If it isn't clear let's make sure it is by morning.

MR. POLLACK: I think the record is perfectly clear, your Honor.

MR. CRACO: I agree.

THE COURT: All right. Please try to be prompt tomorrow so that we won't have to be here in the wee hours of the night.

MR. BRINN: I assume I do not have to appear tomorrow?

THE COURT: You do not, sir. I am sorry you were inconvenienced.

MR. BRINN: No, I enjoyed it immensely.

THE COURT: I am sorry you didn't get a fee.

D A V I D G. B A I R D, a witness called by third-party defendant Charles Allen, being first duly sworn, testified as follows:

DIRECT EXAMINATION

BY MR. POLLACK:

Q Mr. Baird, did Charles Allen ever say to you in words or substance that the Firestone securities were, "The hotest thing Allen ever had"?

A I don't know what you mean by words or substance, but Mr. Allen for the length of time I knew him of 35 years never to my knowledge or recollection ever used the words, "hot deal."

Q Did he do so in this case?

A No; not that I have any recollection of.

MR. POLLACK: Your Honor, on the basis of those two answers I renew my motion to have the third-party claim dismissed as to Charles Allen.

MR. CRACO: Your Honor, I am put at a disadvantage because Mr. Pollack indicated I thought that he was going to ask a non-controversial question.

I want to reserve my right of cross examination on this question or pursue it now.

THE COURT: Pursue it now.

CROSS EXAMINATION

BY MR. CRACO:

Q Mr. Baird, did you and I have a conversation this morning?

A We did.

Q At my offices?

A Yes, sir.

Q In the course of that conversation did we review the circumstances under which this transaction came to your attention?

A Yes, sir.

Q Would you relate to the Court please the circumstances under which you first heard about the Firestone transaction?

A In the office of Allen & Co., as I have done business with them for about 30 years --

THE COURT: I can't hear you, Mr. Baird.

A I beg your pardon.

In the office of Allen & Company, and I have had many meetings with them over 30 years, somebody brought up or mentioned the fact that they were making a private placement of securities of a company called Firestone, and some name, that they were taking an interest in it themselves,

and they had left a small amount in case I would be interested in making a purchase.

I told Mr. Craco that I did not have the funds available for that. I told him also that I had a meeting with --

O Before we get to that phase of it, I want to confine myself to it.

MR. POLLACK: Let the record be clear it was Allen & Company, Inc., and not Allen & Company that was making the private placement.

MR.CRACO: Can we forfeit your reference, since Allen & Co. is out of the case except that as shorthand for Allen & Co., Inc.

THE COURT: Yes.

O Did you in fact meet with Charles Allen and Herb Allen with respect to the Firestone transaction?

A I would not remember those with whom I met or talked. This is four or five years ago; I have done much business with Allen over these years. I might have met with them or it might have been some of their juniors or affiliates who may have mentioned to me the subject of the Firestone situation.

T6

Q Do you recall having had this meeting in Charles Allen's office with others coming and going in the course of your conversations?

A It could be or, more likely, in their trading room where they went quite a lot and where I spent time on many occasions.

Q Now, in the course of the conversation that you had with this Allen partner, would you tell us in words or substance what he said to you?

MR. POLLACK: I object to the form. He did not say an Allen partner.

THE COURT: That's right, he did not.

MR. CRACO: I am sorry, I thought he had.

Q Did you meet Charles Allen or some other partner of Charles Allen?

A My best recollection would be that it was neither, that it was one of the traders or one of his staff members.

Q Do you remember who it was?

A No. As I told you this morning, it could have been one of four or five, and I cannot at this time place him. I am not making excuses, but I am nearly 79 and my recollection isn't quite as good as it was years ago.

So I could not pinpoint now or give you the

identity of the individual who might first have mentioned the subject to me.

THE COURT: You are sure it is not a partner?

THE WITNESS: I would be practically certain it was not a partner.

MR. CRACO: This goes beyond cross-examination but as long as Mr. Baird might be excused, let me ask this question.

Q What did this gentleman tell you in the course of your conversation about Firestone?

MR. POLLACK: Objection; hearsay, your Honor.

MR. CRACO: I am asking for the res gestae, Judge. I am asking what an employee of Allen & Company, Inc. told Mr. Baird about the prospective transaction.

THE COURT: I will take it so we won't have to call him back.

A My best recollection is that I was told that there was an attractive issue for private placement which they had in the office which had been all spoken for except a very small amount, a relatively small percentage of the total, and they thought I might have an interest in it.

Q Did this gentleman -- he was an employee at least of Allen & Company, Inc., was he not?

A Yes, he would be a staff employee or staff member of some character there.

Q Possibly a vice-president?

A I don't know whether they were incorporated at that time or whether it was a partnership.

Q Did this gentleman phone you that the transaction looked good to Allen & Company?

A He was cautious, but he did state, according to my recollection, that those in the office there had in substantial measure subscribed to the participation.

MR. POLLACK: May I have the last answer read?

THE COURT: He told him the office had in substantial measure subscribed to the participation.

MR. POLLACK: I hea that part.

THE COURT: Read it back.

(Answer read.)

Q Did he refer to the fact that friends of the Allens were participating?

A He did.

Q Did he tell you that they were?

A He stated also that friends of theirs were participants in the subscription to this private placement.

Q Did he --

MR. POLLACK: My objection is that this is a conversation --

THE COURT: I understand, Mr. Pollack, and I am taking it subject to the objection so we don't have to call this witness again, and I have it.

MR. CRACO: I am doing it for that purpose and also defensively on their count.

THE COURT: I understand.

Q Did he say to you, in words or substance, that the earnings of Firestone looked good to them?

A I do not recall any statement about the earnings. He did state about the distribution being a senior security and a common stock and I think some conversion facility or some option on common stock.

THE COURT: This is obviously continuing longer than I anticipated.

MR. CRACO: I can finish in a minute.

THE COURT: For a lawyer a minute is two hours.

MR. CRACO: I can stop now, but I will have to bring Mr. Baird back.

THE COURT: I am trying to accommodate him. He is a 79-year-old man. I would rather not drag him back.

Q Did he say anything to you about a stock split?

A No, I don't recall the details; I know that there was common stock and warrants in the senior security.

THE COURT: Just answer the question, Mr. Baird.

Q I have to ask you again, did he or did he not say anything to you about the profitability of Firestone at that time?

A Only in a general way.

Q In a general way, what did he say?

A In a general way, they felt that the prospects were favorable. It was some new type of financing of real estate with which I did not attempt to familiarize myself.

Q Now, having had this conversation with Allen, did you then report the substance of it to Mr. Herzfeld?

A Yes. I went to see Mr. Herzfeld.

Q Yes, you did?

A In general, yes, but not in particular. I was seeing Mr. Herzfeld on other matters at that time.

Q When did you have the conversation at Allen & Company, Inc. to see which you have just referred?

A I would think within two or three days.

Q My question is, when did you have the conversation with the Allen & Company representative?

A It is hard for me to place it, but I think,

this being 1973, October, about four to four and a half years ago.

Q Would it be correct to say that you had it at some period of time prior to your participating in the issuance of the unit that you bought as an agent for the Herzfelds?

A Yes, it would be prior.

Q Some time in early November, perhaps?

A I would think so.

MR. CRACO: Thank you.

MR. POLLACK: I renew my motion to dismiss the third-party claim.

THE COURT: Do you have any cross-examination?

MR. POLLACK: No.

THE COURT: I will reserve on the motion.

I will deny it at this point. I think it is premature.

THE WITNESS: Am I through, your Honor?

THE COURT: You are excused.

(Witness excused.)

(Adjourned to October 19, 1973, at 10.00 a.m.)

WITNESS INDEX

Name	Direct	Cross	Redirect	Recross
Gerald L. Herzfeld (Resumed)	46	57	124	
Leonard H. Fell	130	150		

EXHIBIT INDEX

Plaintiff	Identification	In Evidence
9		56
8-A	111	
16		139
18		142
Defendants		
A		60

vs 71 Civ. 2209

The Firestone Group, Ltd., et al.,

New York, New York
October 19, 1973-10:15 a.m.

(Trial resumed.)

MR. CRACO: May I proceed with Mr. Fell?

L E O N A R D H. F E L L, having been previously duly sworn, testified further as follows:

CROSS EXAMINATION

BY MR. CRACO (Continued):

Q I think when we adjourned with you last evening you were in the process of describing to us some of the ways in which you felt the audit by Laventhol and the financial statement which it prepared and rendered were negligently done, is that a fair statement?

A Yes.

Q One of the acts of negligence, as I understand it, that you were troubled about in your testimony was that you could not find in the work papers of Laventhol any reference to an opinion of counsel in connection with the legal effect of the two contracts respectively of purchase and sale of the Monterey Homes, is that right?

United States of America

vs 71 Civ. 2209

The Firestone Group, Ltd., et al.,

New York, New York
October 19, 1973-10:15 a.m.

(Trial resumed.)

MR. CRACO: May I proceed with Mr. Fell?

L E O N A R D H. F E L L, having been previously duly sworn, testified further as follows:

CROSS EXAMINATION

BY MR. CRACO (Continued):

Q I think when we adjourned with you last evening you were in the process of describing to us some of the ways in which you felt the audit by Laventhol and the financial statement which it prepared and rendered were negligently done, is that a fair statement?

A Yes.

Q One of the acts of negligence, as I understand it, that you were troubled about in your testimony was that you could not find in the work papers of Laventhol any reference to an opinion of counsel in connection with the legal effect of the two contracts respectively of purchase and sale of the Monterey Homes, is that right?

A Yes.

Q And I think I asked you whether or not your opinion would be different if in fact such an opinion had been orally solicited and orally obtained, and I believe your response went not to that question but to the requirement that there be adequate evidence in the audit work papers of such an inquiry; do you recall that exchange?

A Yes, I do.

Q I am trying to summarize it so we can get on with it.

Now I would like to get back to the negligent behavior that you say arose from the failure to make an inquiry and obtain an opinion.

Do you in fact know whether Laventhol or any of its auditors solicited an opinion of California counsel concerning the legal effect of the two contracts in question?

A I could find no such evidence in the papers.

Q Do you know whether or not Laventhol did so?

A No, I do not.

Q All you can say is that if they did you did not find it in the papers?

A Yes, that is correct.

Q Now, the failure to find it in the papers you criticized on the basis of the necessity of having

SOUTHERN DISTRICT COURT REPORTERS
UNITED STATES COURT HOUSE
FOLEY SQUARE, N.Y., N.Y. 10007 TELEPHONE: CORTLAND 7-4580

a complete set of work papers, am I correct about that?

A Yes.

Q But if such an opinion had been solicited and if such an opinion in fact had been received, notwithstanding the fact that no memorandum of the event found its way into the work papers, would the receipt of an opinion that the contracts were legal, valid and enforcible in accordance with their terms from California counsel to the auditors change your opinion as to the treatment that should be accorded to them by the auditors?

A Only in part, sir.

Q In what part would it change your opinion?

A I believe that it would be permissible, therefore, to reflect the purchase and sale in the income statement to reflect the respective receivable and payable on the balance sheet but it would still preclude the auditor from rendering any type of opinion on the financial statement as to its fair presentation.

Q So it is your testimony that, if I can get this correctly, if the auditors had in fact consulted counsel and been assured by counsel that the contracts were effective in accordance with their terms, that it was then proper to construct the income statement in the manner in which the income statement was constructed in Exhibit 7?

A I said the purchase and sale portion. I haven't discovered the deferred income aspect of it.

Q Let's take it a step at a time. It would have been proper to show as gross revenue, as sales, the 15 million dollars acquired or to be acquired pursuant to that contract from the sale of the property to the Ruderian interests.

MR. POLLACK: I object to the form of the question.

The sale was to Continental Recreation Company, not the Ruderian interests.

MR. CRACO: I lapse into shorthand. It was used in the entire pretrial in this case. I will amend the question.

May I have it read back to the vital word?

(The question was read.)

Q To the Continental Recreation, is that correct?

A Yes.

Q And it would not have been negligent, in your opinion, under those circumstances to have so included it in the income statement?

A That is correct. I am trying to answer yes or no. Sometimes it is a little hard. I would say if I saw an opinion of counsel, company's counsel, indicating that a sale and purchase was, in effect, proper, I would think it

should be recorded.

However, if I as an individual still questioned in my own mind its existence I may want to go to an attorney of my choosing, not an advocate of the company, and confirm that view.

Q I understand.

What you are saying is that an opinion of an independent, uninterested attorney might be better than a company attorney, is that right?

A Where the materiality was so major as it was in this case, it is conceivable I would have felt that way, yes.

Q And if you felt that way and you did it, you would regard it as better practice, wouldn't you?

A Yes.

Q And taking the next step, and with all the same qualifications about independent counsel or company counsel, would your answer be the same with respect to reflecting the 13 million dollars, more or less, of money going out of Firestone to the persons from whom it had purchased the Monterey Nursing Homes?

A My answer would be the same as it was before.

Q And it would not be negligent to reflect that in the income statement as sales in connection with the sale to the tune of 15 million dollars to Continental Recreation?

A That is correct.

Q That would not be negligent either?

A That is correct.

Q By the way, apart from the reference that you made yesterday to the necessity of audit papers being complete, for whatever purposes such completness is required, can you address the Court's attention to any other opinion or statement which reflects the necessity that such an opinion of counsel be obtained in writing?

A Well, yes, I think I can.

Q Do it.

A I would read to you two paragraphs of this SAP, Standards of Audit Procedure, that we discussed yesterday and I would read two paragraphs to you.

I refer you to page 36, paragraph 9, which I will not quote, under the caption of "Sufficiency of Evidential Matter."

It says:

"The amount and kind of evidential matter required to support an informed opinion are matters for the auditor to determine in the exercise of his professional judgment after a careful study of the circumstances of the particular case. In making such decisions, he should consider the nature of the item under examination, the materiality of

possible errors and irregularities, the degree of risk involved, which is dependent on the adequacies of the internal control and the susceptibility of the given item to conversion, manipulation or misstatement, and the kinds and competence of evidential matter."

Then paragraph 11 of the same subsection states:

"To the extent the auditor remains " --

Q Excuse me. Was "matter" the last word? "Available."

I thought I read it that way.

Q I didn't hear it. I am sorry.

Paragraph 11 says --

Q Do you want to read paragraph 10 or are you not relying on that?

A I didn't think it was applicable to your question.

Q Read 11.

A Paragraph 11 says:

"To the extent the auditor remains in substantial doubt as to any assertion of material significance, he must refrain from formulating an opinion until he has obtained sufficient competent evidential matter to remove such substantial doubt or he must express a qualified opinion or disclaimer of opinion."

Then I would quote you just one more paragraph,

if I amy. If I can direct you back to page 22 in the same book. paragraph 14, under the general category of the standards of field work. The paragraph reads as follows:

"The matter of due care concerns what the independent auditor does and how well he does it.

"For example, due care in the matter of working papers requires that their content be sufficient to support the auditor's opinion and his representation as to the compliance with auditing standards."

And based upon the three paragraphs I just read is why I said that even if it had been oral I think that it would have been deficient because it would not have met the standards of the three paragraphs I just read to you.

Q Well, under the last paragraph, keep them in front of you, your view is that the absence of a writing reflecting this would constitute, as far as the work papers were concerned, or to be more precise in the matter of working papers, it would constitute, in your opinion, an absence of due care?

A Well, writing need not be necessary. It could be a tape. It would be a recording. Something that's matter. I mean as opposed to the fact that somebody says I heard it. Any type of evidence.

Q But its absence with respect to working papers would constitute as respects those working papers, in your opinion?

A A deficiency.

Q An absence of due care to use those?

A An absence of due care, right.

Q All right.

Negligence, in short?

A I don't want to use the phrase negligence.

MR. POLLACK: Objection to the legal characterization.

MR. CRACO: All right, I withdraw it.

Q Turning to the paragraphs that you did refer me to before, 9 and 11 -- what page were they on again? I'm

sorry I lost it.

A 36 and 37.

Q You did not regard it -- we are talking now about the necessity of having a written opinion or some tape of a written opinion. Paragraph 9 says nothing about a writing or such other evidential material, does it?

A No.

Q Paragraph 11 says nothing about a writing or other such evidential material, does it?

A All through it refers to matter.

Q But neither refers to matter in writing or by tape or otherwise, right?

A Correct.

Q Now, would you read for the Court the paragraph that you omitted, paragraph 10?

A "The independent auditor's objective is to obtain sufficient competent evidential matter to provide him with a reasonable basis for forming an opinion under the circumstances. In the great majority of cases, the auditor finds it necessary to rely on evidence that is persuasive rather than convincing. Both the individual assertions in financial statements and the overall proposition that the financial statements as a whole present fairly the financial position and results of operations of the reporting company, are of

such a nature that even an experienced auditor is seldom convinced beyond all doubt with respect to all aspects of the statements being examined.".

Q Is not the fair intendment of that paragraph to say that an auditor in pursuit of evidence to support an opinion which he has been asked to render, has to take reasonable steps to satisfy himself under the circumstances that the transaction about which he is concerned as a bona fide one?

A No, I don't read that.

Q You don't read that?

A I read it to say that after you have examined the matter, you may not be convinced beyond a reasonable doubt but you have at least taken the steps to examine some matter.

Q But the first sentence does say,does it not, that the objective of the independent auditor is to obtain sufficie competent evidential matter to provide him with reasonable basis for fouring an opinion under the circumstances?

A That is correct.

Q It doesn't say in writing does it?

A No, it does not say in writing.

Q I am not sure that you testified to it but Mr. Haimoff in his opening certainly adverted to it, and while

I hesitate to supply deficiencies of proof, let me approach this question. Is it your testimony that the absence of any written confirmation from a principal of Continental Recreation as to the purchase by it or the execution of a contract to purchase by it of the Monterey Homes was a deficiency in the audit work papers?

A Except for the word written. You see you keep using the word written and I defined written as something script or printed, I say the absence of any type of evidential matter in the papers leading to what you just said.

THE COURT: You mean tangible substantiating.

THE WITNESS: Something I could see in the papers or hear if I put a tape on a recording but it didn't have to be in writing and I want to emphasize that phrase, sir.

I don't think writing is mandatory.

Q Then it is your opinion that no written confirmation of the sale to Continental Recreation was required to be obtained from Rudorian or any other principal?

A No, I wouldn't say that. I would read to you what the book says on it.

Q You just tell me what you say it is.

A I say that in order for an auditor to give any type of opinion, in order to ever certify any statement, it is mandatory that he attempt to get independent verification,

SOUTHERN DISTRICT COURT REPORTERS
UNITED STATES COURT HOUSE
FOLEY SQUARE (LOW) N.Y. 10007

direct communication from the debtor.

Now, it does say in the book that the best way of getting direct communication is to get it in writing, but it does not say that that's the only way to get direct confirmation.

However, there was nothing in the papers at all that there was any type of communication, either in writing, verbally, by tape, phone conversations, nothing in the papers to indicate any type of direct communication.

Q And the net of that is that you don't know whether there was in fact such communication as you come here and testify in court?

A Based upon the papers I examined, I could not form an opinion that there was.

Q And you can't form an opinion that there wasn't, either, can you?

A Well, assuming the work papers are complete, if I --

Q Can you answer my question?

A Based upon the work papers I could not say that they had confirmed it and I could not say they had not confirmed it.

Q You are familiar with paragraph 18 of Chapter 6 of SAP 33?

A Could you give me the page, sir?

Q Page 38.

A Yes, "Confirmations of receivable" --

Q You are familiar with that?

A Yes, I am.

Q You regard it as authoritative?

A Yes.

Q All right. You are familiar with the following language of that paragraph, are you not?

"Confirmation of receivables requires direct communication with debtors. The method and time of requesting such confirmations and the number to be requested are determined by the auditor."

Are you familiar with that?

A That is correct.

Q Do you agree with that?

A Yes, I am, as a --

Q Now, does Chapter 6, as a matter of fact, relate generally to confirmations in commercial transactions?

A I am sorry, I didn't hear the question.

Q To such things as accounts receivable in a company that buys and sells goods as distinguished from something like what we are dealing with her?

A Yes, they do define that where there is a particular transaction it requires more information than scattered

numerous transactions.

Q So that that, what we just read, generally relates to the standard that is applicable to verifying accounts receivable in a commercial retail or wholesale operation?

A No, I don't read that, sir. I say that it refers to receivables in generaly, and that they later define that where you have a series of many receivables, such as as a result of normal sales, you can scatter your confirmation requests, whereas where you have a principal or substantial amount tied up in one, you must take special care to get that particulare one because you don't have as many to draw upon in a stratified sampling,if you will.

Q And you have to do it by direct contact with the obligor?

A Independent verification from the debtor.

Q From the debtor?

A As opposed to from the management.

Q Right.

And the method of doing so and the time of doing so is for the auditor under that standard; is that not correct?

A Yes.

Q If in fact the auditors for Laventhol had made a specific direct communication to Mr. Rudorian in the course of which they inquired about his execution of the contract

on behalf of Continental Vending, his view of the legal binding effect of that contract -- I don't mean Continental Vending -- Continental Recreation -- his view ofthe binding effect of that contract on Continental Recreation, and his intention to pursue that contract to completion in accordance with the terms, would that communication with Ruderian have been a confirmation of the kind referred to in that standard that we have just read together?

A Your last --

Q Forget for the moment whether or not it found its way in written form into the work papers.

A Except for the last sentence the last part of your acceptance and he said he was going through with the deal I think was the phrase you used.

Q Yes.

A That part has nothing to do with the legal obligation. In other words, if he was going through with the deal he maybe said he was going through with the executory contract.

If you stop and drop out the last part that he said he owed the money at that date, and they had gotten that correspondence from him in some way, shape, or form, I would have said that would be proper.

Q All right, let's take that. If he had said, "My

company did indeed sign the contract, and it is a valid and binding obligation on my company," would that have been confirmation of the contract?

A Of the contract?

Q Yes.

A Of the contract, yes, it would have been confirming the contract but not the passing of title or the obligation to pay the debt.

Q And if he then said that he intended to perform the obligations under the contract in accordance with their terms, would that have been some evidence to the auditors that the contract was one which was not only legally binding but which was reasonably likely to be concluded in accordance with its terms?

MR. POLLACK: Objection to the form of the question.

THE COURT: Again, what was bad about it?

MR. POLLACK: I think for one thing it is compound, your Honor, in that it contains in it an implicit assumption that forces this man to answer.

THE COURT: I will sustain it.

Q If Mr. Ruderian had said to the auditors in words or substance that this was a deal that he had made and that he intended to go through with the deal in accordance

with its terms, in your opinion would that have been some evidence to the auditors upon which they could base an opinion that Mr. Rudorian and the purchaser under the contract were reasonably likely to consummate the contract in accordance with its terms?

MR. POLLACK: Objection to the form of the question.

Jumbling Rudorian and Continental.

THE COURT: I will let it stand as it is.

You can clarify it.

A It would give some weight that there is still an executory contract. I am not saying that it means that there is still a valid receivable. Yes, there would be some -- there would be some information that there is a deal still brewing, or a deal still consummated -- contemplated but not yet consummated. You haven't asked me a question -- I want to make sure you are not asking me would that be evidence that the deal had been consummated.

THE COURT: You are saying all of which shows that there is an executory deal.

THE WITNESS: Yes, sir, that is all I am trying to say.

Q But you are saying more than that. You are saying, are you not, that that would be some evidence that the

obligor under that executory contract at the time of the inquiry had the intent to go forward with the contract in accordance with its terms?

A It would reinforce to me that his signature that I saw on the executory contract was now being told that he still has the same opinion he had when he signed the contract to purchase.

Q Do you have Exhibit 7 before you? If not, perhaps Mr. Haimoff would be kind enough to show it to you.

(Mr. Haimoff hands exhibit to the witness.)

Q I'd like to direct your attention to footnote 4.

You testified yesterday -- and I am frank to say I haven't received the transcript yet so I can't cite you the chapter and verse -- but my notes reflect that you testified yesterday that one of your criticisms of note 4 was that reflected that the property had been acquired and had been sold, and that is all you said; isn't that right?

A I recall saying that. I don't know if that's all I said but I do recall saying that -- I said that, yes.

Q That was your characterization of the defect in note 4, was it not?

A I didn't say that was the only defect.

I said that was a defect. I don't know if I said that was the only defect because there were others.

Q That was the only one you were asked about by Mr. Haimoff yesterday but for this purpose that was a defect, is that correct?

A Yes.

Q In point of fact, is that what footnote 4 said?

A Yes, I believe it does.

Q Would you read the entire language of the first paragraph of footnote 4?

A Surely.

"Note 4: The Firestone Group, Ltd. acquired --"

Q Go ahead.

A "-- by contract of sale a group of convalescent hospitals containing approximately 1900 beds. The properties were leased back to the former owners. In November 1969 the company sold the properties by means of a contract of sale. Period."

Q Are you saying that footnote 4 does not adequately disclose that what was involved here was a transfer of contract rights to property?

MR. POLLACK: Objection, your Honor.

THE COURT: Sustained.

MR. POLLACK: That is a matter for the Court to

decide.

A Yes, I --

THE COURT: Sustained.

2b

Q By the way, did you go to counsel for the interested parties to determine what the legal effect of those contracts was?

A No, because --

Q Never mind.

A -- I wasn't preparing a statement. I am merely viewing the work papers.

Q You are only criticizing?

A No, I was asked to review the work papers to see if the work papers were in accordance with generally accepted auditing standards.

Q Let me understand this: was the scope of your retainer in this case solely to --

A I have no retainer.

Q Was the scope of your engagement in this solely to review the work papers and decide whether they were an adequate set of work papers?

A No, sir, it was to review the work papers to see if the work papers were in accordance with the generally accepted auditing standards and that, based upon the work papers, were the accounting principles applied to the financial statement in accordance with generally accepted accounting principles and auditing standards based upon the work papers and other items made available by you of

the work papers of the accounting firm.

Q And among the work papers were the two contracts?

A Among the work papers --

THE COURT: Isn't this getting repetitive, Mr. Craco? It seems to me you had gone into this yesterday. It was quite clear yesterday that among the papers were the two contracts, the executory contracts.

MR. CRACO: Let me just ask two more questions, and then I will continue this line.

Q In forming your opinion about the suitability of the accounting treatment, you took those contracts into account, did you not?

A I took them into account along with -- for instance, there was another piece -- another major document in the papers dealing with the same contract that I took in consideration. There was a memorandum, I believe --

Q Excuse me, you took those contracts into account; is that not right?

A Along with other documentation, yes.

Q Right. Now my question is, in connection with your opinion about the accounting treatment to be accorded those two work papers, did you consult with independent counsel?

SOUTHERN DISTRICT COURT REPORTERS
UNITED STATES COURT HOUSE

MR. POLLACK: Objection, your Honor, irrelevant.

THE COURT: Overruled. Yes or no.

A Well, I spoke to counsel as to his interpretation of it. I couldn't pass judgment.

Q Indicating Mr. Haimoff, the counsel for the plaintiff in this case?

A I asked Mr. Haimoff that -- I said it looked to me that it was an executory contract, but what does he think.

MR. CRACO: May I have an answer to the question, your Honor, as to --

A Yes, I asked Mr. Haimoff. I said it raised a question to me, and I asked Mr. Haimoff that this was my own opinion --

Q Other than plaintiff's counsel, did you ask any other lawyer for an opinion as to the effect of these contracts?

A No, I did not.

Q Did you ask any California lawyer?

A No, I did not.

THE COURT: These contracts were for land, were they?

MR. CRACO: Yes.

THE COURT: Were they specifically enforced?

MR. CRACO: In my understanding, they were, your Honor, in that equitable conversion had occurred.

THE COURT: That is your point.

MR. CRACO: My point is that the auditors were entitled so to regard them, and I will, subject to connection, establish that. I might say, your Honor, that I don't think that this Court is called upon to decide retrospectively the enforcibility of those contracts, only whether the --

THE COURT: The issue to me is a very narrow one: was Note 4 misleading?

MR. CRACO: That's right.

THE COURT: That is what it comes down to.

MR. CRACO: I think that would be the issue if Note 4 had been read, but if you reach that issue, then it does get to the question whether Note 4 was misleading.

Q I show you what I have taken the liberty of marking as Defendant's Exhibit D of this date. It's a letter signed by the Firestone Group.

MR. CRACO: Your Honor, I have marked certain of these exhibits last night. I haven't had an opportunity to prepare copies of them. They are all work papers that have been previously handed over, and my questioning about them will be very brief.

SOUTHERN DISTRICT COURT REPORTERS
UNITED STATES COURT HOUSE
FOLEY SQUARE, N.Y., N.Y. 10007 TELEPHONE: CORTLANDT 7-4580

Q In the course of your examination of the work papers, did you see Exhibit D?

A No, I did not see this, and when I went through the work papers I specifically was looking for something like this.

Q What is something like this? Can you tell us what it appears to be?

A This appears to be what is referred to in the accounting profession as a representation of letter by the management to the auditors, which contains certain boilerplate clauses such as satisfactory title to all assets, satisfactory -- that all the assets are included, that all the liabilities are shown, and since the financial statements are representations of management, the auditors ask for some representation from management about title, et cetera. This is a standard statement. There is one thing, however, that is missing.

Q That is what you recognize it to be?

A As a letter of representation. I would call this a letter of representation.

Q Do you know the -- I don't suppose you can identify it, but do you recognize certain signatures at the bottom?

A Well, only because there is a printed -- the

printed name is above it. I couldn't read the signature itself.

MR. CRACO: May I show this document, Exhibit D, to Mr. Scott, and ask him whether he will represent that one of the two signatures on that document is his?

MR. SCOTT: Yes.

MR. CRACO: I offer Exhibit D.

MR. POLLACK: Your Honor, we object to the receipt of this document in evidence. For one thing it was never produced on discovery. For another, it's undated.

MR. CRACO: As to the first, your Honor, that is flatly untrue. We produced it on discovery.

MR. POLLACK: We have never received it.

MR. CRACO: That may be, sir, but our documents have been available in gross since the beginning of this case for examination, and they have been inspected certainly by Mr. Haimoff's team, and whether you have adequately them or not I can't say. but they have been available for your production; and Mr. David, my associate, has been present when in fact they have been inspected by your people.

THE COURT: I am not impressed with that point. I am with respect to the second. What about it?

MR. POLLACK: Furthermore, it's undated. We have no idea if and when this document was delivered.

MR. CRACO: I will offer it subject to connection, if that should be necessary.

THE COURT: All right, I will take it subject to connection as to date.

xx (Defendants Exhibit D received in evidence.)

Q I direct your attention to the first paragraph of the letter and ask you to read it to the Court.

A "In connection with your examination of the consolidated financial statements of the Firestone Group, Ltd. and it's wholly-owned subsidiaries as of November 30, 1969, we hereby confirm to the best of our knowledge and belief certain information and opinions expressed to you during the course of such examination."

Q In the ordinary course of auditing practice, is a representation letter of that character received during the course of the audit to which it refers?

A Not quite so. This merely refers to certain information without labeling it. Normally in those --

Q The rest of the letter labels it, doesn't it?

A No, it doesn't. I don't think so. This statement, when we issue them -- I can't speak for every

SOUTHERN DISTRICT COURT REPORTERS
UNITED STATES COURT HOUSE

accounting firm in the country -- when we issue them, when we want to make -- when we want the client to give us certain representations, we don't say certain information and certain information and certain opinions. We try to say as follows, and we try to enumerate them chapter and verse rather than say certain information.

Q And the following paragraphs in fact contain certain confirmatory representations, do they not?

A The following paragraphs --

THE COURT: How can you prove the date of this letter by this witness?

MR. CRACO: I beg your pardon? All right.

THE COURT: You are whistling in the dark here, just wasting time, it seems to me.

Q But this is a document you look for?

A We look for a letter of representation.

Q And that is a letter of representation, right?

A Yes.

Q Referring to the November 30 audit?

A Yes.

Q I show you a document which I have marked as Defendant's E for identification, and I ask you whether you have ever seen that document before.

A No, I have not. I would point out to you, sir,

that this appears to be an original copy with the actual affixed signature, and the only papers ever made available to me were Xerox copies of papers that were in your files, so I have never had an opportunity to see any original originals, so to speak, so I didn't see a copy of this.

Q Did you ever see a copy of this?

A No, I did not, sir. As a matter of fact, I would say to you that in our office we don't put these type of letters in the audit file. We keep them in a special confidential file so that they are not mixed up with audit papers, and it's possible for that reason I never saw it in the actual work papers submitted.

Q Or a copy?

A We do not put them in the audit files.

Q Regardless of what you do, did you see a copy?

A No, I have not seen a copy of that letter.

Q The audit which is here complained of was an 11-month audit, was it not?

A I believe it refers -- it doesn't say 11 months.

Q Wait a minute. Before you refer to the document, can you tell the Court for what period of time the audit report was rendered?

A It was rendered for the period from December 26, 1968, through November 30, 1969. That's the description

on the financial statement.

Q Do you know when the fiscal year of Firestone ended?

A I do not know what fiscal year they elected. I know they reported this financial statement as a period covering approximately 11 months and four days.

Q All right.

A But whether they elected that as their fiscal year I have no way of knowing.

Q So you don't know whether or not there was in fact another audit as at the end of January, a year-end audit?

A No, I do -- I have not examined any such documents.

Q In connection with that, you do not know that in connection with the audit for the 12 months as distinguished from the 11-month period, the auditors had in their possession a representation letter that said at the end, "We further represent to you that all transactions and commitment have been conducted and completed on an arm's-length basis"?

A May I see that, sir?

(Paper handed to the witness.)

A May I answer you, sir?

SOUTHERN DISTRICT COURT REPORTERS
UNITED STATES COURT HOUSE

Q Answer me, by all means.

A I see a letter here dated May 26, 1970, stating that everything was entered in an arm's-length transaction, but the report we are referring to is dated December 6, 1969, and it is a generally accepted auditing standard that accountants are responsible only to those transactions up to the date that they signed their report, which in this case was December 6, 1969. This letter is 1970.

Q Do you know whether, between November 30 or December 6, 1969, and May 26, 1970, the contracts which are Exhibits 12 and 13 had matured to any further state?

A I know that there were additional requirements in between that period. There was a payment due in December, '69, to the seller of the land.

Q Do you know whether that was made?

A No, I do not know. It was not made -- there is nothing in the work papers on 1969 that indicated anything had occurred after November, 1969.

Q Do you know whether it was made?

A No, I do not.

Q One of the other criticisms you levelled at the handling of the transaction, as I understand it, was the supposed inconsistency between reporting income in part on the basis of $185,000 derived, as you understood it, from liquidated damages, and the fact that the sale

SOUTHERN DISTRICT COURT REPORTERS
UNITED STATES COURT HOUSE

had been taken into revenue in the firstplace. Is that a fair summary of that portion of your critique?

A I think it's a fair summary of what I said.

SOUTHERN DISTRICT COURT REPORTERS
UNITED STATES COURT HOUSE

BY MR. CRACO:

Q Now, in the installment method of accounting for such transactions, is it not true that the accountant is called upon to make an evaluation of the portion of a profit derived from a transaction which should be taken into current income based upon various considerations?

A Under the installment method, the income of a transaction is reported in proportion to the collections, so that if the company had elected, which the statement doesn't say, but if the company had elected to report this income on the installment method it would have had to gear its profit in relation to the collection, which would mean if they had received $25,000 by November 30th and had elected the installment method, they would have been able to take that fraction of which $25,000 is the numerator and 15 million dollars is the denominator and say that fraction which is some .0000 something times two million dollars would have been proper to be treated as income if they had elected the installment method of accounting, which they didn't according to the statement that I have read.

Q Do you agree with the proposition that in handling the amount of income that should be taken into current net income all the circumstances should be considered and the consideration received in the transaction reasonably

evaluated?

A I think that's a fair statement, yes.

Q Now, in the process of reasonably evaluating the consideration that should be taken into net income in the current period, what factors do you think ought to have been considered?

A Well, let me say this:

Any time there is a question of when income is to be reported, which we refer to as a timing question, the first decision we have to come to or the first judgment we must come to, is whether or not the income has been earned.

If we then come to the conclusion that the income has been earned, we then try to find a procedure by which we will recognize for accounting purposes the income in various periods. and among the procedures that are used is to evaluate that by saying, "We'll pick up the income in proportion to the collections," or "We'll pick it up in proportion to the amount of services that will be rendered."

In other words, we try to gear the recognition of the income over some criteria of collection to something else, but only after you have established that the income has been earned.

Q Once you have established that the income has been earned, it is up to you to make some, as an auditor

and a person giving an opinion on such things, to make a judgment of how much of it should be timed in this accounting period?

A Yes, but --

O Is that right? It's a judgment matter?

A Yes, but subject to it could never be more than the amount I have received to date.

You have used the word installment.

O Forget my reference to installment.

A I am answering your question, I thought.

O I don't want to argue with you.

A Okay.

O In the process of realizing income which is received over a period of time, does it not require the auditor to make a judgment as to timing, as you phrased it, as to what accounting periods various portions of that income should be received in?

A Where he elects the installment method. If he doesn't elect the installment method then all the income is reported when it is earned.

O And in the process of determining the income that should be taken into the current period, is not the auditor obliged to give effect to amounts which are reasonably likely to be received in the period or immediately after the period

which is in question?

A Not necessarily, because -- I will give you one specific example. We have certain pronouncements. There is an organization called the Accounting Principles Board.

Q Before you go on with that literature, you say not necessarily. Do I take it from that that your answer is under certain circumstances it is possible?

A Under certain circumstances possibly.

Q And a judgment of how much to take into current income and how much to defer in some matter which an auditor is obliged to exercise some judgment on, is that right?

A Yes, in accordance with generally accepted accounting principles.

Q And in the course of exercising that judgment, is it also not true that the auditor is obliged to take into account all the economic realities of the transaction that he has before him for which he is attempting to make a suitable?

A Absolutely.

Q And if it were clear that even if the transaction were disaffirmed $185,000 would, in accordance with the terms of the contract, be receivable immediately as liquidated damages, is that not one of the factors that an auditor would be entitled to consider in making the judgment as to

his evaluation?

A No, sir.

Q In your opinion, it is not?

A Because it is an alternative.

Q It is not?

A I can't say that yes or no. What you are asking me is it is an alternative. Either it is proper to record the profit on the transaction if there was a transaction or, in the alternative, you can set up and s[illegible] picking up potential liquidating damages only because I may not have a deal."

But to say, "I have a sale and I have a liquidating damage," is inconsistent and for that reason -- it is alternative.

They are mutually exclusive of each other.

Q Let's consider whether in fact they are.

The exercise that the auditor has to go through at this point is to determine how much of a gross profit has to get deferred, right?

A Yes, he has to determine a procedure to defer a portion of the gross profit.

Q And the net income results from his subtraction from the gross profit of the amount which he defers?

A When you defer gross profit, it is tied in, as

I said before, with the collection payout, so that if you are talking about a potential collection of 15 million dollars and you want to know how much of a two million dollar profit you should defer on a 15 million dollar sale, you would take that portion uncollected of the 15 million dollar and say -- which I gave you the fraction before.

In this case it would seem to me that using the arithmetic it would be necessary to defer almost the entire $2,030,500 since the amount collected was such an infinitesimal percentage of the total contract price.

But you can't tie in the amount earned vis a vis the liquidating damages against the deferred income. They are mutually exclusive of each other in my judgment as an auditor.

Q Now, did you in the course of your examination of the work papers make any attempt to discover whether there were expenses associated with the purchase or sale of this property?

A I found no work papers which would indicate that there were any other expense to this transaction other than the payment of $25,000 received from Continental Recreation and a payout of $5,000 to I think it was Monterey, I think was the original seller.

Q Did you consider whether any portion of the

legal expenses which had been deferred would have been -- excuse me. Let me rephrase the question.

Did you consider whether any portion of the legal expenses which were taken as current expenses on the books would have been unnecessary in the event the transaction had not gone forward?

A If there were such legal expenses, I think it would have been proper to -- if the management had elected to defer those expenses and later write them off at the time of the consummation of the sale, I think it would have been proper. But I really cannot tell you whether they did it or not. I don't recall having examining such papers.

Q Do you know whether there was any provision for income tax in respect to this matter?

A As a matter of fact, the company only reflected on its income statement the liability for income taxes based upon the earned income of $130,000.

Q What was that amount?

A That is approximately --

Q $37,000?

A I have to look, sir. Somebody took the statement away from me.

(Pause.)

A The company reflected income taxes of roughly $38,000, I believe. However, I didn't finish the statement. Even with the deferred income of $1,795,000 accounting treatment requires that when you set up deferred income you set up the deferred tax that will be made when that deferred income is reported.

So that even the inclusion of $1,795,000 of deferred income should have had set aside from it the potential tax of approximately, I would say, 50 per cent of that one million dollars, or another $900,000, because that deferred income when earned does not belong to the corporation. Half of that would go out in the form of taxes. You must match up the future tax against the future income.

Q You have to match up the present expenses against the present income, don't you?

A That is correct.

Q And in your answers to Mr. Haimoff about the impact of eliminating this profit, you did not take into account in your calculations the expenses which would also be eliminated from the financial statements, did you?

A I answered you I didn't have any. If there were any, I would not have eliminated them, that is correct.

Q You did not eliminate the tax which was attributable

to the earned income, did you, in your response to Mr. Haimoff?

A No, I --

Q Yes or no, did you?

A That was not the question Mr. Haimoff asked. You are assuming an answer. The answer I gave I recall distinctly was that the financial statement reflected an income before taxes of $104,000, which, if this $235,000 had not been recorded, would have reflected a loss before taxes of approximately $130,000.

I never in my answer referred to the after tax computation because I never made such a computation.

Q Did you consider any bonuses which were earned by Mr. Firestone or Mr. Scott in connection with this transaction?

A No, I did not.

MR. POLLACK: I object to the line of questioning, your Honor. There is no evidence there were any such bonuses or other expenses.

Q Were there?

A I answered you I have not seen any. I have seen no computation of either expenses, bonuses included in these financial statements that relate to this Monterey transaction.

Q When you say "these papers," are you referring to the ones you extracted from the work papers or are you

referring to the work papers as a whole?

THE COURT: How much longer do you expect to be with this one witness?

MR. CRACO: About five minutes.

THE COURT: He testified on direct for about a half hour. You have had him on cross now for well over two hours.

MR. CRACO: Judge, it is very easy for someone to get up and say Laventhol's audit stinks in five seconds, and my obligation is to show that his opinion is improvident and it may take longer.

THE WITNESS: Your Honor, I am a professional man. The phraseology he used, I am a professional, I don't like him to say I said that about a co-professional. I haven't said that.

MR. CRACO: I was just indicating the brevity of the direct.

THE WITNESS: Don't ascribe it to me, sir.

MR. CRACO: Very well, I won't.

Q How many audits have you supervised in the last year?

A 50 to 100.

Q You personally hav supervised?

A Yes. As the partner in charge I have had

subordinate supervisors, managers, but the buck stops here, so to speak.

Q On how many occasions in the last year have you testified or assisted others in testifying in court on matters relating to other peoples' financial statements?

A In the past year?

Q Yes.

A This is the first time.

Q In point of fact, you are testifying later this afternoon, are you not?

A No, sir. I mentioned to you that I was supposed to be on an examination before trial on another matter which I postponed in anticipation I was going to be here today.

Q Without getting into the question of explicit testimony, is it not a major part of your practice to assist in the preparation of cases against accounting firms?

A No, to the contrary, this is the third time in my life I have been involved on it. I have been involved in reviewing bankruptcy investigations, but it is the third time I have been called upon to either testify -- this is the third time I have been on the witness stand as, "an expert witness," if you will.

I couldn't retire on the amount of time I put in on it.

MR. CRACO: That's all.

THE COURT: Mr. Pollack?

MR. POLLACK: No questions, your Honor.

MR. HAIMOFF: I have nothing further, your Honor.

THE COURT: You are excused.

(Witness excused.)

MR. HAIMOFF: If your Honor please, I have no other witnesses.

THE COURT: Do you rest?

MR. HAIMOFF: Except for one or two minor matters which I would like to now refer to.

With respect to the evidence which has been adduced on the subject of whose securities these were, General Investors or the plaintiff Gerald Herzfeld, I would like at this time, your Honor, pursuant to Rule 21 of the Rules of Federal Procedure, to move to amend my complaint to add General Investors Company as a party plaintiff and to amend the allegation of the complaint which alleges that Gerald Herzfeld purchased the securities so that that allegation will read Gerald Herzfeld individuall and on behalf of General Investors Company, a co-partnership, purchased the securities which are referred to in that paragraph of the complaint.

MR. CRACO: If the Court please, I oppose the

the motion. For some three years this litigation has been prosecuted on behalf of Mr. Herzfeld both against ourselves and against other defendants.

It has been settled and other parties dropped out. There has been ample litigation and discovery in the matter. To amend the pleadings at this juncture to alleged that the purchase was made by persons other than that disclosed by paragraph 7 of the complaint without having given us an opportunity to explore the issues of reliance, causation and damages with regard to the other co-partners, Saul and Nathan Herzfeld, would seriously prejudice our position.

It seems to me that Mr. Herzfeld for reasons best known to himself has prosecuted this action for three years in his own name, and I don't think he has been the real party in interest at any point except to one third of that amount, and I have refrained from making a motion under 17(A) to dismiss on the grounds that he was not.

On the other hand, it seems to me that his cause lies only to the extent that he has been injured and only to the extent that he can show the requisite violation as to him of 10b-5, a matter which I will address on my motions in a moment.

But it seems to me that to amend the complaint to allow in under the tent two new parties as to whom we have

never had discovery and as to whose requisite reliance and causation we have had no opportunity to explore would be seriously prejudicial to us and for that reason we oppose the motion.

I might say that motions to amend pleadings to conform to the proof are appropriate with respect to the charging allegations of a complaint in certain circumstances, but I submit, your Honor, they are no substitute for an appropriate motion to add indispensable parties under other rules of the Federal Civil Procedure which pertain to motions to add or drop parties, and I refer particularly to I think it is Rule 45 and Rule 17.

So I oppose the motion as being made out of time and on the other grounds I recited.

MR. HAIMOFF: If your Honor please, I am sure Mr. Craco is aware, and of course, your Honor is, Rule 21 specifically provides parties may be added at any time either by the Court sua sponte or on application of any party on such terms as may be just.

As a matter of fact, in the annotations in the rules in Moore's, which sets forth the rule, there is specific reference to situations in which parties have been added on appeal.

Now, of course, if in fact there were any serious

prejudice to the defendant resulting from this application, perhaps that is something that the Court ought to consider. I see no prejudice, your Honor.

If Mr. Craco is concerned about reliance on that issue, which is the only point he specifically mentioned, I am prepared to agree and, as I have indicated before, this is what the Court may do under the rule upon such terms as may be just, I would be prepared to agree that the other partners, Nathan Herzfeld and Saul Herzfeld, are bound by the testimony which Mr. Gerald Herzfeld has given on that point.

As a partner in General Investors he would have a clear right to bind the partnership and his testimony would have been exactly the same. He read the income statements, he didn't read Note 4. There is no question about that. We don't dispute it. Examining Nathan Herzfeld or Saul Herzfeld would add nothing whatever in view of the fact, as I say, your Honor, I have agreed to stipulate that neither Saul Herzfeld nor Nathan Herzfeld read anything other than the income statements.

So the testimony would stand precisely the same as to them as it now stands as to Gerald Herzfeld.

THE COURT: Could you give me again how you want to amend it exactly?

MR. HAIMOFF: May it be read, your Honor?

Tb

THE COURT: Yes.

MR. HAIMOFF: I want to amend the caption --

THE COURT: The substance.

MR. HAIMOFF: That the allegation in the complaint which now alleges that Gerald Herzfeld purchased the Firestone securities, that that paragraph be amended.

THE COURT: How do you want to amend it?

MR. HAIMOFF: Gerald Herzfeld individually and on behalf of General Investors Company, a co-partnership, purchased the securities alleged in that paragraph. Simply the phrase "on behalf of General Investors Company, a co-partnership," is the amendment.

MR. CRACO: If your Honor please, it is bad even as to form. He either purchased it individually or he purchased it as one of the co-partners of General Investors but not as both.

THE COURT: He could buy it, I suppose, individually and as agent for the other two.

MR. HAIMOFF: I don't want to now preclude the Court's finding on the evidence as to just who purchased what.

MR. CRACO: I don't want to make a big deal about this beyond the fact that I feel prejudiced.

THE COURT: How are you prejudiced? Specifically,

how are you prejudiced?

MR. CRACO: I am prejudiced by this: on the assumption that we are dealing with Mr. Herzfeld's purchasing as an agent for his brothers, it is insufficient for me to rest on the fact that Mr. Herzfeld's testimony as to what he read is binding on and would be given by his brothers if they were called, because the net effect of that, while I grant that Mr. Herzfeld's testimony on reliance was damaging to him, I don't think that Saul Herzfeld, for example, ever read even the income statement of the Laventhol report or Nathan Herzfeld ever saw the Laventhol report.

So that to the extent that they are claiming on their own right or are attempting to be brought in through an agency theory here, the fact of their non-reliance, personal non-reliance, is an object --

THE COURT: Under the agency theory, they certainly can rise no higher than their agent who handled the transaction.

MR. CRACO: But maybe not so high. That is my point.

THE COURT: I am not convinced that you are prejudiced on an agency theory, not at all. I will grant the motion.

MR. HAIMOFF: Just one more point, your Honor.

If your Honor will observe, the pretrial order which has been submitted and signed by the parties refers to certain mailings which were made the purpose of which was to establish the mailing requirement.

When Mr. Craco and I discussed the form of the order, he said, "Type it up in this form and I will let you know whether I accept it."

I spoke to Mr. Craco --

MR. CRACO: Based upon Mr. Herzfeld's testimony.

MR. HAIMOFF: Yes, based upon Mr. Herzfeld's testimony. Mr. Craco has now advised me that he considers that there is an issue as to mailing.

Now, with respect to that, I have obtained from the work papers of the Laventhol firm the records which indicate numerous uses of the mail. I don't know that it is necessary for me to refer specifically to them. I would like to offer these documents as Plaintiff's Exhibit 37, which I believe substantiate and evidence the use of the mails by the Laventhol firm, although it would seem to me the Court could almost as a matter of judicial notice find that you can't sell seven and a half million dollars of securities by a California firm to New York investors without using the mails and the long-distance

telephone.

I offer these documents in evidence.

MR. CRACO: If your Honor is disposed to take judicial notice of the last item, I will not require that the record be burdened with these documents.

THE COURT: Let's put it in.

MR. CRACO: I have no objection for that limited purpose.

THE COURT: Received.

x x (Plaintiff's Exhibit 37 received in evidence.)

MR. HAIMOFF: The plaintiff rests.

MR. CRACO: I now move to dismiss the plaintiff's case as amended for failure to make out a prima facie case, and I would rely for this motion, if the Court please, on three propositions.

First of all, I take the position that the evidence submitted to the Court at this point has been utterly insufficient to show that there was anything wrong in fact with the Laventhol report. In other words, I think the record is barren of anything except the suppositions of hindsight with regard to whether in fact the transaction was improperly recorded on the financial statement.

There isn't a single shred of direct evidence offered by Mr. Haimoff to contradict the effect of the contract nor any evidence whatsoever introduced other than the suppositions, not even the opinion, but the assumptions of Mr. Fell that that transaction was not properly recorded. I rest on what the record says about that and pass to the second point.

2 Even if Mr. Fell's testimony was to be taken whole as competent evidence in this case, there are two glaring features about it that it seems to me make it absolutely clear that no prima facie case has been made.

On his very first responses to my very first questions today and on several subsequent responses to those questions and without any rehabilitation by Mr. Haimoff on redirect, Mr. Fell testified that if certain things of which he complained were true, they would have constituted negligence.

And the law is amply clear that a demonstration of mere negligence by an auditor in the proferring of financial statements is insufficient in law to support a claim under 10b-5.

We have now exchanged trial briefs, Mr. Haimoff and I, and I know that his position as a matter of law to you is that he will show the negligence of Laventhol in the

conduct of the audit and the rendition of the financial statement.

THE COURT: Are you suggesting that I am bound by an accountant's opinion? Am I precluded from finding negligence because an accountant says it is negligence or precluded from finding fraud or misleading statements?

MR. CRACO: I think you are bound by the record.

THE COURT: I am trying to get your legal position. Is it your position that the Court is precluded from finding misleading statements here or failure to disclose facts which would make the statements made not misleading or fraud in one of its other variations simply because an accountant says that this was negligence?

MR. CRACO: In a sense I am saying that.

THE COURT: I thought you were.

MR. CRACO: But I want to be sure you understand in what sense I am saying that. I am saying that the burden of proof of establishing that the wrongdoing on the part of Lubenthol rose to the statutory requirement is on the plaintiff, and in making the determination as to whether or not a wilful, reckless abandon characterized their work here, to paraphrase the Texas Gulf Sulphur case, it seems to me you are bound by the showing that plaintiff has proferred, and on this record the only showing that

has been offered on that is one of mere negligence out of the mouth of this accountant.

So while I don't as a general rule say that you are bound by the characterizations of expert witnesses as to the conduct of others, I do say that that's the most that's been proferred on this direct case and that that record binds you in your determination as to whether a prima facie case has been made.

To turn the thing around, and this is the second thing, there is not one scintilla of proof on the prima facie case of the plaintiff that there is the requisite scienter to support a private damage action in this circuit for violation of 10b-5. Neither the quantum of recklessness that was mentioned in Judge Friendly's opinion in SEC v. Texas Gulf Sulphur and which has been adopted in the Lanzer v. Drexel case as fairly characteristic of the standard of proof required for scienter is remotely met by the record here, and Mr. Haimoff has to show on his prima facie case one of two things. He either has to show that Laventhol by itself and in it acted knowingly and willfully and wrongfully in the promulgation of this audit, or it has to show by more than his sayso that it acted in concert with others in the course of aiding and abetting a conspiracy which was knowingly and wilfully

entered into by Laventhol.

He has shown neither, and whether you regard it as a characterization on the part of this witness as the whole proof on the character of the wrongdoing, if any, which Laventhol was guilty of or whether you regard it as an utter absence of proof of the requisite scienter, the plaintiffs' case is barren of one of the requirements at this juncture that they must show in order to sustain a cause of action under 10b-5.

The third proposition on which I would rely is that the plaintiffs' case very plainly establishes by a fair preponderance of the evidence on the plaintiffs' case that the plaintiff himself did not rely on the Laventhol statement nor could it be said under the circumstances revealed by the plaintiffs' own case that the Laventhol statement as distinguished from the accumulative effect of Baird and what Baird said about Charley Allen and what Kramer said about Charley Allen and what Firestone's unaudited statement said and what the Firestone certificate from the president said and what the letter from Firestone characterizing the Laventhol letter said, there can be no doubt, it seems to me at this juncture, given the fact that he picked one line out of the Laventhol statement and then did not read the note to

which it referred, there can be no doubt that the Laventhol statement was not the proximate cause of any damages he sustained here.

As we have indicated in the supplemental brief that we have submitted to the Court on this question, there must be a causal nexus.

It reminds me, Judge, you asked me about personal reliance in these cases, it reminds me of what Justice Potter Stewart said about obscenity in his famous concurring opinion. He doesn't know how to define it, he says, but he knows it when he sees it.

Your Honor has not seen that causal connection between the alleged wrongdoing of Laventhol, if any there be, and Mr. Herzfeld's investment decision. On the contrary, you have seen it flatly denied.

He relies upon an opinion which he didn't read, which if he had read would have mandated that he took the financial statements as a whole, and he did not, and we submit that the plaintiffs' case is bereft of the requirements it has to contain in order to sustain a cause of action under 10b-5 both because there is no showing of wrong by competent proof, no showing of scienter by any proof and no showing of reliance or causation or that the transaction was in connection with a purchase and

sale of securities since they had been purchased before the Laventhol statement was even glanced at.

So, your Honor, we submit that we should not be put to our proof, which would be cumbersome and difficult, about the audit when the fact is that the audit was never relied on in the course of the investment decisions that were made by Mr. Herzfeld in this case.

We submit, accordingly, that the plaintiff has failed to make out a prima facie case either under its pleading as originally stated or under its pleading as it is now amended, and for that reason we now request that you rule as a matter of law a prima facie case has not been sustained and dismiss the complaint for insufficiency of proof.

MR. HAIMOFF: Mr. Craco has made, I think, two or three separate points, if your Honor please, and I would like first to address myself to the question as to whether or not the proof that we have offered makes a prima facie case of culpable or reckless negligence tantamount to fraud on the part of the Laventhol firm.

I believe, your Honor, that the evidence is overwhelming that there was such reckless indifference to the facts which proves beyond any doubt, and I believe beyond any defense, that the Laventhol firm, through its

agents in the California area who were working on this audit, lent themselves to an obvious phony scheme by Richard Firestone.

And if you review the evidence on the points, it goes far beyond what Mr. Fell said.

You have in the first place a memorandum dated November 21, 1969, prepared by a Miss Amerson, who is an assistant to Mr. Scott.

MR. CRACO: Excuse me. I regret interrupting counsel. The Amerson memorandum was never introduced in evidence, and had it been I would have objected to it most strenuously.

THE COURT: I hadn't heard it before.

MR. HAIMOFF: It was marked, your Honor.

MR. CRACO: It was marked for identification in the pretrial but I reserved my right to raise a ruckus about it when it was offered.

MR. HAIMOFF: It was one of the group of exhibits. I can quite understand the situation which has developed. It was one of the group of documents which I considered to have been received in evidence, which Mr. Craco produced for my examination in the course of discovery proceedings, which were in the possession of Mr. Fell when he was testifying, and I had assumed --

it may be erroneously -- if I did I apologize for it and I would like to offer them now and have Mr. Craco make any objection he chooses. This was a mistake on my part.

I assumed that the Court's direction was to mark the exhibits and review them with counsel. They were referred to in the pretrial order and I assumed they were in evidence.

THE COURT: I don't see how you could possibly get that assumption. I clearly instructed you yesterday to offer your exhibits in evidence.

MR. HAIMOFF: You did, your Honor, you did.

THE COURT: That is not to say you are to be heavily penalized for an inadvertent mistake.

Do you move to reopen your case for the purpose of offering this exhibit?

MR. HAIMOFF: May I reopen plaintiffs' case, if your Honor please, for the purpose of offering in evidence all of the documents which I made available to Mr. Fell and upon which and with respect to which he gave testimony?

MR. CRACO: I have no objection for that limited purpose.

THE COURT: Motion granted.

MR. HAIMOFF: I offer them in evidence for all purposes.

MR. CRACO: I am responding to your motion to reopen.

THE COURT: Mr. Haimoff, first you reopen. Now offer them.

MR. HAIMOFF: I offer them in evidence.

THE COURT: Now let's hear his objection, if any.

MR. HAIMOFF: May I identify the documents I am offering?

THE COURT: All right. Just by number.

MR. HAIMOFF: Plaintiffs' 11 through 25, consecutively.

MR. CRACO: Bear with me for half a moment, your Honor.

(Pause.)

MR. HAIMOFF: I would like to add, your Honor, the documents Mr. Craco is now examining are specifically referred to in paragraph 15 of the pretrial order.

(Pause.)

MR. CRACO: Your Honor, I have no objection to the receipt of any of the documents with the exception of Plaintiffs' Exhibit 17, which purports to be a memorandum

from D.L. Amerson to R.M. Firestone dated November 21, 1969.

I consent to the admission of this memorandum solely for the purpose of establishing that such a memorandum was in the work papers of Laventhol because indeed it was and it was produced as such. I object to it as rank hearsay if offered for the proof of its contents.

MR. HAIMOFF: I offer it for one purpose and one purpose alone: as proof of the fact that this was information which came to the attention of the Laventhol firm.

THE COURT: I will accept it for that purpose.

MR. CRACO: I think that is the same thing I said.

THE COURT: Yes, not for the truth of what is said in it but for the fact that it was information that came to the attention or should have come to the attention of Laventhol. All right.

MR. HAIMOFF: My contention is that the facts referred to in the memorandum are not true. That is precisely my contention, your Honor.

xx (Plaintiffs Exhibits 11 through 25 received in evidence.)

MR. CRACO: May I now inquire whether Mr. Haimoff rests again?

THE COURT: Yes.

MR. HAIMOFF: Yes, your Honor.

THE COURT: You rest now?

MR. HAIMOFF: Yes, hopefully.

THE COURT: Now, let's have your response to the motion.

MR. HAIMOFF: Starting then with his memorandum which is prepared, as I say, which purports to have been prepared by Miss Amerson, who is Mr. Scott's assistant, as the exhibits indicate, which specifically refers to the fact that we have entered into an agreement for the purchase of real property for $10,000,000 and specifies certain terms and says, "We have sold the real property for $11,400,000," and then on the following day, apparently, a contract which is dated November 22 is entered into in which, somehow or other, the purchaseprice gets to be $13,000,000 instead of $10,000,000 and then a few days later a contract is entered into which refers to a price of $15,000,000 instead of $11,400,000, so that overnight, practically, a potential profit of $1,400,000 --

THE COURT: Mr. Haimoff, sometimes we are getting the cart before the horse here all the way. First you have to prove that there was some misleading representation of some kind. What is that misleading representation?

We go back to Torts One, the five elements of deceipt, and they are essentially the same under the Securities Act so let's have what is the false representation or the misleading representation.

MR. HAIMOFF: The false representations are as follows, if your Honor please:

Plaintiff's Exhibit 7-A, sales,$22,132,607. That's false by 15 million dollars.

THE COURT: All right. Let's assume that.

Who read it?

MR. HAIMOFF: Mr. Herzfeld specifically says he read it. That is the income statement which he says he read, Gerald Herzfeld.

MR. CRACO: I must say he --

THE COURT: Isn't that in Footnote 4?

MR. HAIMOFF: Oh, no, oh, no. I am sorry, your Honor doesn't have a copy of it.

MR. CRACO: I beg your pardon, your Honor, I think the testimony will be most clear that Mr. Herzfeld said he read the deferred profit line of the income statement.

THE COURT: That is my recollection of what he said.

MR. HAIMOFF: My recollection of his testimony your Honor, is that he said he read the income statement.

MR. CRACO: We have daily copy so we could find that.

MR. HAIMOFF: He said that he paid particular attention to the deferred profit figure as confirming the unaudited financials. That is my recollection of his testimony.

THE COURT: If you have the transcript there perhaps you could be guided.

MR. HAIMOFF: Even if, your Honor, I don't know exactly what he testified to, it may be that Mr. Craco and your Honor are correct as to just what he said, even if -- and I am willing to assume for the purpose of this argument -- even if Mr. Herzfeld had said that he read only the deferred gross profit item on Plaintiff's Exhibit 7-A, that is such a material and overwhelmingly significant representation, we are not -- when you talk about reading just one line out of 25 lines, that sounds like it is very unimportant, but what you are talking about is the key to the alleged profitability of this enterprise.

THE COURT: You don't have to label it significant. All I am trying to find out is what was the representation.

That is number one.

Number two is was that representation false?

Number three, I suppose his eye was the material?

And number four, was it relied on?

And five, was there damage? That is what I want; and in that order. When I say representation and falsely, I mean in the broader term of the Securities Act.

MR. HAIMOFF: The false misrepresentation is the statement on Plaintiff's Exhibit 7-A that there was a deferred gross profit of $1,795,500.

THE COURT: Why is that false?

MR. HAIMOFF: It is false because it is predicated upon two contracts, Exhibits 13 and 14, which do not represent consummated transactions, which were executory contracts, which were never enforced, and never enforcible, and which involve a situation on the facts where the Court could find that this was a transaction which was rigged for the purpose under circumstances which establish that all that Firestone paid was $5,000, and all that Continental Recreation paid was $5,000; that under the circumstances where it appears that the corporation is about to sell seven and a half million dollars of securities, so that the motive to falsify is clear, and where there is nothing in the record which establishes or nothing in the work papers which

establishes anything which remotely indicates that this is a genuine transaction.

There is a reference to a lease, for example, in the contract, a sale and lease back.

There is no lease in the file. There is a reference to convalescent hospitals. Well, now, how can you buy and sell hospitals without some reference to whether they are licensed hospitals, whether they have equipment, what equipment do they have, and you are dealing with hospitals in ten or 15 different states. The states are not indicated.

If you analyze the documents themselves, if your Honor please, they themselves, I believe, are prima facie proof of fraud, which should have been apparent to anybody, let along an expert auditor under those circumstances, and taking into account all of the other factors.

THE COURT: How do you show that it was knowingly made by Laventhol?

MR. HAIMOFF: Well, they had the papers, your Honor. They didn't bother to check with -- they had the papers. Anybody looking at that contract purportedly involving the sale -- the purchase in the first place by Firestone of 25 or 30 hospitals in different counties, where the counties aren't specified, in different states where the states aren't specified, from some Ohio corporation

with a reference to a lease back, all that is available to Laventhol. They have the paper. Mr. Lipkin testified to it; and presumably if he is called upon he will raiterate that testimony.

The point of the matter is that the documents, our contention is, on their face, prove that this is a rigged transaction, or that the Court could properly, in the absence of an explanation by Laventhol, draw that inference.

That's why we claim the transaction is false, it was an option if at all, if it had any legal significance at all or any meaning at all, it was at most an option on the part of Firestone to buy these hospitals, and an option on the part of Ruderian or Continental Recreation to buy them, if he raised the capital; and there is nothing to indicate that either one of them ever had the slightest intention of going through with this deal after the transaction -- after the -- after they obtained the seven and a half million dollars. And they never did, as the evidence shows.

So that's why we claim at least prima facie, subject to an explanation by Laventhol, that that statement was false.

Now on the question of reliance, we have the fact that at least as to this it is conceded that Mr.

Herzfeld read that figure.

In any event, so far as the damages are concerned, we have the fact that $510,000 was paid, that a claim -- that there has been a recovery of $357,000, so that our claim is for the difference, plus interest from the time that the money -- or the transaction -- was consummated.

Essentially that is our position.

MR. CRACO: May I respond briefly, your Honor?

THE COURT: Briefly, yes.

MR. CRACO: First of all, your Honor, I think there are two major, and a lot of minor, problems with Mr. Haimoff's prosentation. I won't trouble you with the minor ones. I think they are adequately dealt with in the brief's that we have submitted.

The two major ones are that Mr. Haimoff assumes what I think we just established he was not entitled to assume when he reopened his case to submit certain evidence.

In other words, he argues to you that, as if he had some proof that the transaction reflected by Exhibits 12 and 13 were "obviously phoney transactions."

Now there isn't a dot of evidence to that effect, so he tries to make that up by quoting the substance of the Amberson memorandum as saying that on such and such a date this state of facts pertained, as if in fact it did;

but your Honor received the Amberson memorandum specifically indicating that he was not receiving it for the proof of the truth of the contents thereof, and in the absence of the proof of those contents thereof, Mr. Haimoff's argument from them is improper, and his proof is absent.

He has taken the position, and it is an essentially bootstrap position, that if he can show a transaction, characterize it as obviously phoney without proof thereof, and then say that because it was obviously phoney based on his characterization, Laventhol should have reached the same conclusion, he can therefore impute to Laventhol a knowingly misleading statement; but the advice of that chain is that he has no proof of the underlying fact on which his case depends, that the transaction was, as he put it, obviously phoney.

His judgment as to what is obvious I am afraid does not satisfy the requirements of a prima facie case, as that on the question of whether there was wrongdoing, never mind knowing wrongdoing, we depend upon his characterization of a transaction. There isn't a piece of evidence in here that these contracts are not legal, valid, enforcible and binding in accordance with their terms.

THE COURT: But there isn't any question, is there, there is no dispute, title hadn't passed?

MR. CRACO: There is no proof, your Honor, in this case.

THE COURT: Then how would you --

MR. CRACO: I am sorry, I hadn't finished my answer. There is no proof in this case that those contracts under California customs and usage were not perfectly adequate to pass equitable title and require accounting for the transaction in accordance with its terms.

THE COURT: Assuming that they were contracts for the purpose of land specifically enforcible sufficient to work an equitable conversion, nonetheless, is it not misleading to tell the purchaser of stock that you have acquired certain property when all you have is a contract?

MR. CRACO: If that is all you said, perhaps, but if you said you acquired it by contract of purchase and sold it by contract of sale which is what Note 4 says, the purchaser would be on notice that the relevant instruments were not deeds but contracts, and the advice -- the second major advice in Mr. Haimoff's presentation is that that explanation, that the relevant instruments were contracts of purchase and contracts of sale, was contained in Note 4, which his client admittedly did not read.

Now, the issue about reliance and causation was brushed off by Mr. Haimoff by saying that he had --

that the testimony is clear that Mr. Herzfeld read the line about deferred profit.

Well he read the line. He did not read the note that the line specifically refers to; but I want to take further issue, your Honor, with the characterization that Mr. Haimoff makes of what the misrepresentation under the best set of circumstances in his case is.

If he is suing Laventhol for a misrepresentation contained in its opinion; because the financial statements are financial statements of the company, and the only representation that an accountant makes is that they fairly reflect the financial condition of the company; and the testimony is uniform on the plaintiff's own case that that representation that they fairly reflect the financial condition of the company runs as Mr. Fell sat here and said to the whole package, to the entirety of the financial statements taken as a whole, not one line extracted from it.

And if he had read the financial statements taken as a whole, he would have seen that they were contracts of purchase and sale, not deeds. He would have seen the treatment accorded the deferred income. He would have seen that the collectability of the portion of the income which was deferred was an element of qualification in the account's opinion; but he did not read the representation, the only

representation which can be laid to the accountants here, namely the representation contained in their opinion.

That is the only representation an auditor makes, and it is the only representation, I might draw the Court's attention to, that any auditor has ever been held liable in this or in any state court for, on a certified set of financials.

I am not quite finished yet.

I don't think that the issue of reliance and causation, which must establish a nexus between the misrepresentation of Laventhol, not of Firestone, but of Laventhol, and the damages claimed by the plaintiff, has been made nor do I believe that that insufficiency of proof can be papered over by the assertion by Mr. Haimoff that admittedly he read one line out of seven pages of report. That one line we think accurately portrayed the circumstance to which it referred taken together with the note which reveals the character of the instruments involved, and the transaction in detail.

In short, we say that there was nothing misleading about the misrepresentation taken on its terms. There was no causation between any misrepresentation and the damages here and Mr. Haimoff, relying as he does on a body of "obvious facts," "obviously phoney transactions," has to

be put to his proof, that the transaction was phoney, that it was not what it was purported to be, and he has utterly failed to show that by any competent evidence in this record.

MR. HAIMOFF: I think we are now, if your HOnor please, at the heart of the case. How do you prove a fraud? It's very rare,if your Honor please, that you have testimony of witnesses who heard conversations between the conspirators in which they say, "Let's rig our statement," you don't have that.

You have in practically all cases of fraud that I have ever heard of circumstances from which the Court draws an inference of fraud.

Now here sometimes, your Honor, that if your Honor would look at those contracts themselves -- suppose, for example, just to illustrate my point, this was a contract to buy the Brooklyn Bridge, and a contract to sell it at a profit of 40 million dollars.

Now then Mr. Crace could say, "Well how do you know? What evidence do you have that they were not really buying and selling the Brooklyn Bridge?"

Well, I don't know what evidence I could adduce on that subject. Just all I could say was, if your Honor please, these people are buying and selling the Brooklyn Bridge, and isn't that ridiculous, isn't that phoney.

THE COURT: Was it false that they had been leased back to the former owners?

MR. CRACO: The question really is, is there any proof in this record that it was false.

THE COURT: Is it false?

MR. HAIMOFF: I say this, your Honor, that where -- this I think is very important and it goes back to a statement made by Judge --

THE COURT: It's all important. I am asking you to tell me what your evidence is.

MR. HAIMOFF: A statement made as of knowledge where knowledge there is none, is fraud.

That is what I am about to say.

THE COURT: I am not asking you, where is it false.

MR. HAIMOFF: Because they had no right to make that statement that there was a lease back when they never saw any lease, and that's why it is false. This implies that they knew there was a lease back, that they had knowledge of a lease back. They had no such knowledge. That's why it's false.

THE COURT: You are saying they say it is a lease back when they didn't know whether or not there was one?

MR. HAIMOFF: Exactly and every other statement is false for the same reason.

And that is exactly my situation here.

THE COURT: To get away from the Brooklyn Bridge and come to the case at hand, is there anything in Footnote 4 that isn't so?

MR. HAIMOFF: Anything in Footnote 4?

THE COURT: In Footnote 4 that isn't so?

MR. HAIMOFF: Yes, your Honor. The first statement which your Honor has referred to is a flat affirmative misstatement of fact.

"The Firestone Group, Ltd. acquired by contract of sale a group of convalescent hospitals containing approximately 1900 beds."

That statement is false. The Firestone Group for $5,000 had not acquired anything, and they had an option and the Amberson Memorandum describes it as an option; so that the Lavantol firm was at least on notice that one of the principals or one of the employees in the company talked of it as an option, and the contract itself indicates that it was an option, and this statement is flatly false.

Now the properties are leased back to the former owners. Where is that in the file? Where is there any proof of that? That should have been in the working papers. There is no reference to any lease.

In November 1969 the company sold the properties. That's false.

THE COURT: All right. I will deny the motion.

Take a short recess.

(A recess was taken.)

MR. POLLACK: May we have just one moment until the witness comes in, your Honor?

MR. POLLACK: In the interim --

MR. CRACO: Before you proceed, Mr. Pollack, may the record indicate, your Honor, that pursuant to your permission yesterday, the third-party defendant will proceed at this time on the corporate claim, and we will reserve the defendant's case until the conclusion of his case.

THE COURT: Yes.

MR. POLLACK: Your Honor, I have prepared for your use during our part of the case a set of exhibits with an exhibit list. It's an extra set A-1 through A-20.

THE COURT: Thank you very much.

MR. POLLACK: The list is on the inside left of the folder.

THE COURT: Thank you very much.

(Folder handed to the Court.)

MR. POLLACK: Also for ease of reference in our case, I have marked them A-1,A-2 and A-3, A standing for

for Allen.

THE COURT: All right.

MR. POLLACK: I call to the stand Mr. Chester Wadley, your Honor.

C H E S T E R P. W A D L E Y, a witness called by third-party defendant Allen, being first duly sworn, testified as follows:

DIRECT EXAMINATION

BY MR. POLLACK:

Q Mr. Wadley, were you employed by the Firestone Group, Ltd. in November and December 1969?

A I was.

Q In what capacity?

A I was controller of the corporation.

Q When did your employment commence?

A July 11, 1969.

Q When did your employment terminate?

A I resigned as an officer of the corporation on February 20, 1970, remained as a caretaker employee until sometime in May 1970.

Q What were your duties as controller in November and December 1969?

A I was in charge of all accounting matters, all general administrative matters and all personnel matters.

Q Were you responsible for the maintenance of the financial books and records of Firestone?

A I was.

Q Did there come a time in November 1969 when you closed the books of Firestone?

A That is true.

Q When?

A We closed the books on Thanksgiving, the 27th day of November. We closed them as of the 25th.

Q Why did you close the books?

A I was requested to do so by Mr. Firestone in preparation for an audit.

Q Are you aware that Lavanthol issued a report and financial statements for the period ending November 30, 1969?

A Yes.

Q Excuse me -- and dated December 6, 1969?

A I am aware of that.

Q I show you a document and ask you whether you recognize Exhibit A-5 as that report and those statements.

A There were two reports.

Q Please, I asked you a specific request.

A This one, okay, yes, I recognize it.

MR. POLLACK: I offer it in evidence.

MR. CRACO: May I see it, please.

(Handing to Craco.)

MR. CRACO: May I inquire whether this is the same as Plaintiff's Exhibit 7 in evidence?

MR. POLLACK: I believe it is but I have not followed with intense care the Plaintiff's exhibits. I thought it would be easier to mark these.

MR. CRACO: I have no objection to admissibility. I don't know that we need to burden the record with two copies of the same thing.

THE COURT: We will receive it.

MR. POLLACK: As a matter fact is is the same, your Honor.

xx (Exhibit A-5 received in evidence.)

Q Mr. Wadley, as of December 6, 1969, the date of the Laventhol report and financial statements, did the financial books and records of Firestone, which you were responsible for maintaining, contain any entry showing a 15 million dollar sale to Continental Recreation Company?

A No.

Q As of December 6, 1969, were you, the controller, aware of a 15 million dollar sale to Continental Recreation Company?

A No, I was not.

Q As of December 6, 1969, did the financial books and records of Firestone contain any entry showing an asset of 13 million dollars of nursing homes?

A No, they did not.

Q As of December 6, 1969, were you aware of the existence of an asset of Firestone consisting of 13 million dollars of nursing homes?

A No, I was not.

Q Mr. Wadley,did there come a time when you were instructed to make entries on the financial books and records of Firestone showing a 15 million dollar sale to Continental Recreation Company?

A Yes, there came such a time.

Q When?

A December 19, 1969.

Q Who so instructed you?

A Mr. Morris Schwab of Laventhol.

Q Did he do so by letter?

A Yes.

4b

Q I show you a document which is marked Exhibit A-14, and ask you whether that is a copy of the letter he sent to you dated December 18, 1969, instructing you to make those entries.

A This is a copy of the letter.

MR. POLLACK: I offer it in evidence.

MR. CRACO: No objection.

THE COURT: Received.

(Third-Party Defendant Exhibit A-14 received in evidence.)

Q Mr. Wadley, I show you another document marked A-19 and ask you whether A-19 is the enclosure which you received with the letter from Mr. Schwalb; in other words, the journal entries that he was instructing you to make.

MR. CRACO: May I see A-14 again, please?

(Document handed to Mr. Craco.)

A It is my recollection that there were additional entries other than these that were sent to me at that time.

Q Are these entries, which include 56 in number, among those that you were instructed to make?

A Yes, they were among them.

MR. POLLACK: I offer it in evidence.

MR. CRACO: No objection.

THE COURT: Received.

(Third-Party Defendant Exhibit A-19 received in evidence.)

MR. POLLACK: At this time, your Honor, I respectfully call the attention of the Court on Exhibit A-19 to entry No. 24, which appears on page 9, instructing the booking of the so-called continental transaction.

MR. CRACO: Excuse me, your Honor, I haven't up to this point objected to the use of the word "instructing," but I don't know whether it's appropriate, and I wonder if Mr. Pollack can find a different word. I will object to the form of the question.

MR. POLLACK: I think the letter from Mr. Schwalb speaks for itself.

MR. CRACO: I think so, too, and I think we --

THE COURT: All right, let's let it speak for itself.

Q Mr. Wadley, you were the controller of Firestone at all times during this audit by Laventhol; is that correct?

A Thatis correct.

Q During the audit, were you ever consulted by Laventhol or anyone else about the adjusting entries you were asked to make by Mr. Schwalb's letter of December 18?

A No, I was not.

Q Incidentally, was the letter which you received from Mr. Schwalb telling you to put these various entries on the books dated and received by you subsequent to the private placement of seven and a half million dollars?

MR. CRACO: I object to the form of the question, your Honor. The document is in evidence and speaks for itself.

THE COURT: It is dated, isn't it?

MR. POLLACK: The question is objected to. I merely call the attention of the Court to the fact that the adjusting entries were instructed to be made by letter of December 18, two days after the private placement was made, and 12 days after the Laventhol report was dated.

THE COURT: All right.

Q At any time during the audit, Mr. Wadley, did Laventhol ever question you about the $15,000,000 sale to Continental Recreation Company?

A No, they did not.

Q At any time during the audit, did Laventhol ever mention to you anything about the $15,000,000 sale to Continental?

A No, they did not.

Q Mr. Wadley, were you excluded from any aspect of the audit?

A Yes, I was.

Q Please state to the Court in what respect you were so excluded.

A After the field workwas completed, the representatives of Laventhol met with Mr. Firestone without my presence and discussed the audit.

MR. CRACO: Excuse me, if it's a meeting without his presence, I don't know how he can competently testify to what was discussed at it.

MR. POLLACK: I don't think he plans to.

THE COURT: I hadn't heard him say what was discussed, did you?

MR. CRACO: I thought he began to say and they discussed. May I have the reporter read the last words?

THE COURT: If he did, I missed it, and I apologize.

MR. CRACO: May I have the reporter read back the last answer?

(Last answer read.)

MR.POLLACK: Strike "and discussed the audit," please, at our request.

Q Please continue with your answer, Mr. Wadley.

A I thought that was a complete answer. What am I missing?

Q I was asking you to tell the Court the circum-

stances of exclusion from the audit.

A Mr. Firestone had a private office, customarily kept the door locked. I know that representatives of Laventhol came, I saw them, and they went into his office and met with him and I was excluded.

Q Were you ever locked out of the office of Mr. Firestone at a time when he was in there with Mr. Lipkin?

A Yes.

Q Can you state the occasion or circumstances under which that occurred?

A There were a number of meetings between Mr. Firestone and Mr. Lipkin and his office was always locked.

Q How do you know that it was locked?

A I tried the door several times at various occasions. He continually kept his door locked. It was a matter of fact. It was not just because of this.

Q Mr. Wadley, when for the first time did you see the Laventhol report of December 6 and the accompanying financial statement which I have shown you before and which has been received in evidence as Exhibit A-5?

A Are we talking about the --

Q A-5 is the statement I showed you which is the one that was used in the private placement, as I understand it.

MR. CRACO: I object to the form of the question. Why don't you show him A-5 and get through with it.

A I can tell very quickly.

(Paper handed to the witness.)

Q When did you receive that?

A Approximately December 15. I do not have an exact recollection.

THE COURT: Just so the record will be clear, what year?

THE WITNESS: 1969. Sorry.

Q Had you, Mr. Wadley, ever been given another statement prepared and signed by Laventhol and dated December 6, 1969?

A Yes, I did.

Q When?

A Approximately December 9, 1969.

Q I show you a document marked Exhibit A-4 and ask you whether that is the statement to which you refer?

A Yes, this is the statement.

MR. POLLACK: I offer it in evidence.

MR. CRACO: May I ask a question on the voir dire?

VOIR DIRE EXAMINATION

BY MR. CRACO:

Q I draw your attention to the first page of Exhibit A-4 where the notation "Withdrawn and superseded" appears. The same notation appears on the page with the opinion and on the page on which Footnote No. 4 appears, along with certain other marginal notations. When you saw A-4 on or about December 9, were those notations on it?

A No.

Q In point of fact, when you received A-4, did it have clips at the top or was it in some sort of bound form?

A It was bound.

MR. CRACO: I object to it, your Honor. It is obviously authentically what he received.

THE COURT: Are you objecting to the whole document or merely to the notes that are on it?

MR. CRACO: I am objecting to the whole document, your Honor, on the grounds that no proper foundation has been laid for its admission through this witness.

THE COURT: I am afraid your meaning escapes me. I would like your exposition on it.

MR. CRACO: Your Honor, this witness testified that on a certain date he received a document.

THE COURT: He identified this as the document.

MR.POLLACK: Could I cut the argument short? We offer it without the handwriting. I didn't intend to offer it with the handwriting on it. It was my error.

THE COURT: All right. He is objecting to the whole document.

MR. POLLACK: That I don't see.

THE COURT: As I understand your objection.

MR. CRACO: Yes, sir, and my objection is because the portion of the document on which these notations -- which purport to vitiate the pages on which they refer are the opinion page and the Note 4 page and the cover page of the whole document. The first page, your Honor, to which I am referring is the page which embraces the entire document.

MR. POLLACK: Maybe we can cut into this, your Honor. Mr. Lipkin has already said that this document bears his signature, Lavonthol, Krakstein, Horwath & Horwath. I don't see any question about its admissibility.

THE COURT: Your objection is overruled except as to the notations that the witness says were not there at the time he received the document.

DIRECT EXAMINATION CONTINUED

BY MR. POLLACK:

Q Mr. Wadley, what happened to this first state-

ment dated December 6 after you received it?

A I actually received several copies of it, all bound. I took one copy to the City National Bank because the vice-president of the City National Bank, Joseph Lipshur, had been urgently requesting a recent financial statement, and I presumed at the time this was the final document.

A day or two later, Morris Schwalb of Laventhol, called me and said, "Chet, get all copies of this report back to me at once. There will be hell to pay if we don't get them back, and don't send them by mail, send them by messenger."

I returned the copies that I had on hand, but I did not return the copy that the City National Bank had because I couldn't get it.

Q Did you subsequently reobtain that copy from the City National Bank?

A Yes. After I got the revised report, I then went to the City National Bank and induced Mr. Lipshur to give me back the copy that he had, and I gave him a new copy, and the copy that he gave me back is the only copy I had left, and that is the copy in question here.

Q You say you gave him a new copy. Do you mean you gave him a new copy of the second statement that you

received, December 15?

A That's correct.

Q To your knowledge, was there any disclosure in the second statement of the fact that a first statement bearing the same date had been issued and had been pulled back by Laventhol?

MR. CRACO: If your Honor please --

THE COURT: Sustained.

MR. POLLACK: In that event, your Honor, I merely call the attention of the Court respectfully to the second statement which is barren of any reference.

THE COURT: Which is what?

MR. POLLACK: Barren of any reference to the fact --

THE COURT: That is Exhibit what?

MR. CRACO: Both 7 and A-5.

MR. POLLACK: A-5.

THE COURT: All right.

Q Mr. Wadley, at the time that you were instructed via the December 18 letter to book the $15,000,000 sale in the financial books and records of Firestone, were you also instructed by Laventhol to make certain other entries?

A Yes.

MR. CRACO: I object to the form of the question.

Auditors don't instruct controllers to do these things, and to the extent that later an argument canbe made about supervision and control, I don't want that verb in the record without --

THE COURT: All right, let's strike the verb. Tell us what was said.

MR. POLLACK: Your Honor, may I respectfully --

THE COURT: Please, will you listen a minute, Mr. Pollack?

MR. POLLACK: I am sorry.

THE COURT: Ask the witness what he was told, what was said. That is how you do it.

MR. POLLACK: The conversation was not oral. It was a writing.

THE COURT: All right, put it in.

MR. POLLACK: It is Exhibit A-14.

THE COURT: Put it in evidence.

MR. POLLACK: It is in evidence.

THE COURT: Then it speaks for itself.

Q I quote to you, Mr. Wadley, from Exhibit A-14:

"Dear Chet:

"Enclosed are the journal entries which we generated for the financial statements at November 30. They are broken down into various entities,

with one exception," and so on and so on.

It goes on to say, "Since we have just about completed the tax return, it is a must that the books be closed in accordance with those entries."

Did those entries, in addition to containing the ones pertaining to the $15,000,000 alleged sale to Continental Recreation, also contain entries relating to deferred charges?

A Yes, they did.

Q Did you have at that time, when you received the letter, any reaction to the entries relating to deferred charges?

A It was my opinion that the deferred charges were excessive in view of the facts available to me.

MR. CRACO: Excuse me, your Honor.

THE COURT: In view of the facts what?

THE WITNESS: In view of the facts available to me of the operations of the company.

MR. CRACO: I move to strike that answer, your Honor, on the grounds that his mental reaction at that time is immaterial to any issue here.

THE COURT: Sustained.

Q Is it the fact that these deferred charges --

MR. POLLACK: Which I ask the Court to take

notice of as part of Exhibit A-19, which we have put into evidence.

Q Is it the fact that these entries relating to deferred charges were not on the books and records of Firestone as of December 6?

A That is correct.

Q How much did those deferred charges amount to, Mr. Wadley?

A Something over $800,000.

Q Mr. Wadley, to your knowledge, as of the time that you left the employ of Firestone Group, Ltd.. was the sale to Continental Recreation Company ever consummated?

A No.

Q As of the time that you left the company, was the purchase of the nursing inns for $13,000,000 from Monterey Nursing Inns ever consummated by Firestone Group, Ltd.?

A No.

MR. POLLACK: No further questions.

MR. CRACO: What is your Honor's disposition with respect to lunch?

THE COURT: About a quarter to one.

MR. POLLACK: Your Honor, I might observe that

this man is from California, and he would like to go back if we could possibly give him such time as he needed to complete his testimony.

THE COURT: I have a grand jury reporting at 12.45, so proceed. We will use up what time we can. I would like to accommodate him. You were an awfully long time in your cross-examination of a certain accountant.

MR. CRACO: I understand that. I could accommodate Mr. Wadley a little better if I had any idea he was going to be called.

CROSS EXAMINATION

BY MR. CRACO:

Q On what date were you instructed by Mr. Firestone to close the books?

A I was instructed by Mr. Schwalb --

Q By Mr. Firestone.

A I was instructed by Mr. Schwalb to close the books as of November 25 in a letter.

Q Do you have that letter with you?

A I have it.

(The witness hands a paper to Mr. Craco.)

Q I notice you have detached it from some other papers.

A These are some personal papers which are an

analysis, which are personal.

Q They don't relate to this litigation in any way?

A No.

MR. CRACO: May I have a moment to look at this?

(Pause.)

MR. CRACO: I offer this as Exhibit F, your Honor. Except for certain apparent notations on Exhibit F it appears to be substantially identical with Defendant's Exhibit C, but it seemed to me since there were such notations on it, it ought to be separately marked.

MR. POLLACK: Your Honor, was that document offered in evidence?

MR. CRACO: Yes.

MR. POLLACK: May I see it, please?

(Paper handed to Mr. Pollack.)

MR. POLLACK: No objection, your Honor.

THE COURT: Received.

(Defendant's Exhibit F received in evidence.)

xx

3

Q Your testimony was that Mr. Schwalb instructed you to close the books on November 25; is that right?

A That is correct.

Q In point of fact, Exhibit F refers to a dis-

cussion on November 17, 1969, between you and Mr. Schwalb, does it not?

A Yes.

Q Would you tell us in words or substance what you recall of that discussion which letter purports to refer to?

A We discussed the date at which the audit was to be started, what period of time I needed to get the books ready for the audit.

We discussed the manner in which the audit was to be conducted, various and sundry points that are normal between an auditor and a controller.

Q Was the conversation, as you recall it, looking towards the execution of a prompt and proper audit by Laventhol?

A Yes.

Q Your testimony was that, by virtue of this letter, you had been told to close the books at November 25, but was that all that you were told to do in the first item of Exhibit F?

A The first item says, "You will close the books as of November 25, but accrue expenses on an estimated basis through November 30."

Q Was there any point in time on or about November

17 when you understood that only matters which were on the books at November 25 were to be included in the statement that was reported as at November 30?

A No, there was not.

Q It is a fact, isn't it, that it's a very normal procedure in an audit to close the books for the purpose of commencing the audit, but then to make certain adjusting entries to the books after the close of the audit to reflect the transactions that had not yet been posted?

A That is correct.

Q Nothing unusual about that, is there?

A No.

Q In point of fact, this letter, which I don't believe that Mr. Pollack elicited from you, asked you to do a whole lot of things to prepare for the audit, doesn't it?

A It does.

MR. POLLACK: Objection, your Honor. It speaks for itself.

THE COURT: Sustained.

Q Did you understand the letter of November 17, Mr. Wadley, to be an attempt by Mr. Schwalb pursuant to a conversation he had with you to collect all the things that

SOUTHERN DISTRICT COURT REPORTERS
UNITED STATES COURT HOUSE
FOLEY SQUARE, N.Y., N.Y. 10007 · TELEPHONE: CORTLANDT 7-4580

you as the controller could helpproduce in order to get an accurate reflection of the financial picture of Firestone for the purposes of his doing an audit?

MR. POLLACK: Objection to the form of the question.

THE COURT: Could I have the question, please?

(The pending question was read.)

A That is correct.

THE COURT: Sustained. It's too compound.

MR. POLLACK: Please don't answer until the Judge rules, Mr. Wadley.

THE WITNESS: Oh, sorry.

THE COURT: It's compound.

MR. CRACO: I am sorry, I didn't understand it to be compound, but let me try it again.

THE COURT: I am afraid I did.

Q Was the purpose of this letter as you understood it to record the understanding that you had developed with Mr. Schwalb in the conversation referred to in the first paragraph?

MR. POLLACK: Objection, your Honor. It calls for speculation as to what was in the mind of Mr. Schwalb.

THE COURT: Overruled.

MR. CRACO: I am asking for what was in the mind

of Mr. Wadley, if I had been permitted to finish.

THE COURT: I heard what you said, and I overruled the objection, and I would appreciate your not turning this courtroom into a debating society.

Answer the question, Mr. Wadley.

MR. CRACO: Your Honor, I hadn't finished the question when Mr. Pollack interposed his objection, but if the reporter could read it back as far as I went, I will take an answer as far as I went.

(The pending question was read.)

Q Please answer the question in that form.

A Yes.

Q And was the purpose of that conversation to decide how to approach the audit for the purposes of making sure that you as controller produced everything that you could produce that would be pertinent to the audit?

A Yes.

Q Did you have any impression in the course of that conversation that Laventhol was trying to avoid looking at anything that you had to produce that would accurately reflect the affairs of the company at that time?

A No.

THE COURT: We will recess now until 2.15. Are you able to give me any prediction now with some accuracy

about how much longer we will be on this case?

MR. CRACO: About what, your Honor?

THE COURT: With some accuracy can you predict how much longer this case is going to take?

MR. CRACO: Let's start with the gentleman who is putting in the proof?

THE COURT: What about your case?

MR. POLLACK: Your Honor, I would say that, assuming that your Honor does not sit Monday, we can certainly complete it Tuesday.

THE COURT: You cannot complete it today?

MR. POLLACK: No. We just started with our first witness, your Honor.

MR. CRACO: It might be helpful, your Honor, and this is not abnormal, as you know, in pretrial situations, which we haven't had the opportunity to have here, if Mr. Pollack would disclose to us what witnesses he intends to call, because I could very easily be prepared better for cross-examination.

THE COURT: I don't see how you can say you didn't have an opportunity for pretrial. I don't recall that anyone asked for one. I recall my taking two days off because a witness wasn't here, and directing you to have a pretrial, and offering to make Magistrate Jacobs available

SOUTHERN DISTRICT COURT REPORTERS
UNITED STATES COURT HOUSE
FOLEY SQUARE, N.Y., N.Y. 10007 TELEPHONE: CORTLANDT 7-4580

to you if you wanted one, and you said you didn't think you needed him, if you did need him you would advise me, so don't please make those misstatements. I am not impressed by them.

MR. CRACO: I don't mean to misstate, your Honor. We did hold such a pretrial conference, which Mr. Pollack did not attend, and we had contacted Magistrate Jacobs for the purpose of resolving any disputes that might have arisen, and none arose.

I am just asking at this point, your Honor, if Mr. Pollack in the interests of expedition would disclose what witnesses he intends to call so that I can be prepared to cross-examine them expeditiously or tell you that I don't intend to cross-examine them.

MR.POLLACK: I think that that is higly inappropriate.

THE COURT: No, tell him your witnesses. We aren't playing games.

MR. POLLACK: Also, I would like to point out he talks about this pretrial conference. We were called at 1.30 for a 2 o'clock conference.

MR. CRACO: But we were all under pressure, Judge.

THE COURT: Of course you were. The case has

only been pending three years. Great pressure.

MR. POLLACK: 2.15, did you say?

THE COURT: 2.15.

(Luncheon recess.)

- - -

AFTERNOON SESSION

2:45 p.m.

MR. SCOTT: I have been here for two days and I fail to see that my presence is needed. I am requesting I be allowed to leave. I cannot afford to keep coming back and forth at varied counsels' whims and I feel no real interest in this matter and I am requesting I be allowed to leave.

THE COURT: If you have anything you wish to testify to or any evidence you wish to offer in this case, you can do it now out of order.

MR. SCOTT: I don't have any.

THE COURT: You have a right to stay here and to be present, but, of course, like any other right, you can waive that right if you choose to do so, you understand that?

MR. SCOTT: I do.

THE COURT: By doing so you are subjecting yourself to whatever judgment comes out of this trial. Do you understand that?

MR. SCOTT: I understand.

THE COURT: And whatever your role may be.

MR. SCOTT: I understand.

THE COURT: If you freely and voluntarily wish to waive your right, you can.

MR. SCOTT: I do. I will leave it in the hands of the Court as to its decision.

THE COURT: Does anyone here wish to call Mr. Scott as a witness?

MR. CRACO: I do.

THE COURT: Let's put him on out of order.

MR. CRACO: Mr. Scott and I discussed this before your Honor came on and I understand he agreed to come back on Tuesday to be taken in order.

MR. SCOTT: I don't know whether I am legally obligated to come back on Tuesday.

Between now and Tuesday I will find out whether I am legally obligated to attend on Tuesday. If it is found by my counsel, whose advice I will have to obtain in some way, that I am required to come back, I will. If not, I shall not. I don't know whether legally I am --

THE COURT: Have you subpoenaed him?

MR. CRACO: No. He came to court under circumstances that you know about, and I thought he was going to stay here for a while. I didn't know I had to. If I had to, I would have. I had an understanding with Mr. Scott arrived at in a conversation --

THE COURT: Put him on out of order and solve the problem.

MR. CRACO: Yes, your Honor, I will try. I will agree to that.

M A R T I N A. S C O T T, called as a witness by defendant, being first duly sworn, testified as follows:

DIRECT EXAMINATION

BY MR. CRACO:

Q Mr. Scott --

THE WITNESS: Your Honor, am I required to testify now?

THE COURT: You are called as a witness. Everyone has an obligation to testify. Proceed.

MR. CRACO: If the Court please, I call Mr. Scott at this time on the defense of the case in chief, on the defense of the counterclaim of the third-party defendants who are counterclaiming and on my own defense in chief.

THE COURT: In short, for all purposes. Proceed.

Q Mr. Scott, in November 1969, were you employed by the Firestone Group, Ltd?

A Yes, I was.

Q In what capacity were you so employed?

A Vice-president.

Q Were you a director of the corporation?

A I believe so.

Q In that period of time, did there come an occasion when you became involved with a financing which the Firestone Group Ltd. planned to enter into?

A What do you mean by "involved"?

Q Did you know that the Firestone Group Ltd. planned an issue of certain securities?

A Yes.

Q And did you discuss that from time to time with Mr. Richard Firestone?

A Yes.

Q And was he also a stockholder of Firestone?

A To the best of my knowledge, yes.

Q Was he a majority stockholder?

A Yes.

Q Did you hold stock?

A Yes, I did.

Q Now, in addition to yourself and Mr. Firestone, were there any other directors of the Firestone Corporation?

A Yes.

Q Is it your recollection that you did or did not, in your capacity as a director, deal with the questions presented to Firestone management arising from the proposed financing -- I will withdraw the question.

THE COURT: I would appreciate it if you would

all keep your voices up a little. The acoustics here are very bad. There is a big hall to fill and I have trouble hearing you up here.

Q I show you Defendant's Exhibit G of this date and ask you if you can tell me what that document is?

A It reads, "Minutes Of A Special Meeting Of The Board Of Directors Held November 13, 1969."

Q Does it reflect who was present at that meeting?

A Yes, it does.

Q Were you present at that meeting?

A Yes.

Q Are those in fact the minutes of that special meeting?

A Yes.

Q And do the minutes bear your signature at the end as secretary of the meeting?

A Yes, they do.

MR. CRACO: I offer them in evidence.

Q Does your examination of Exhibit G refresh your recollection as to your involvement in the financing that was placed by Firestone through Allen & Company, Inc.?

MR. POLLACK: Excuse me, your Honor. May we at least pass on this exhibit that is being offered before we go on?

MR. CRACO: Certainly, your Honor. I will withhold the question.

MR. HAIMOFF: I have no objection.

MR. POLLACK: No objection.

(Defendant's Exhibit G received in evidence.)

xx

Q Do you remember the question, Mr. Scott?

A No.

1B

THE COURT: Mr. Scott should have an opportunity to object to it as well.

MR. CRACO: I am sorry. He does indeed.

MR. SCOTT: I do not.

MR. CRACO: I wonder if the question can be read back. The witness says he doesn't recall.

(Question read.)

A Yes, it does.

Q Now, did there come a time in November of 1969 when you became aware of certain transactions between the Firestone Group, Ltd. and others relating to what we called in this case the Monterey Nursing Homes?

A Yes.

Q And how did that matter come to your attention?

A I believe that the documents referred to as varied exhibits, both contracts of sale, were placed upon my desk and generally information was told to me by Mr. Firestone regarding the situation.

Q And from that date on, would you tell us what connection, if any, you had with the implementation of those transactions?

A It was my responsibility to attempt to gather additional exhibits and reports relative to the exhibits referred to in the contracts.

Q And did you in fact attempt to do so?

SOUTHERN DISTRICT COURT REPORTERS
UNITED STATES COURT HOUSE
FOLEY SQUARE, N.Y., N.Y. 10007 TELEPHONE: COrtlandt 7-4580

A Yes, I did.

Q And did you obtain those exhibits as they were made available?

A Little by little, yes.

Q Did you have conversations with Mr. Firestone about these transactions?

A Yes.

Q In the course of any of those dealings, either with Mr. Firestone or with others, did it ever come to your attention that the transaction by which Firestone bought the Monterey Nursing Homes was not genuine?

A No.

Q Did it ever come to your attention that the transaction by which Firestone entered into a contract of sale to sell the Monterey Nursing Homes to Continental Recreation was not genuine?

A No.

Q To the best of your present recollection and based upon your familiarity with the transactions at the time, were both the purchase and the sale of Monterey Nursing Homes by Firestone pursued in good faith and at arm's-length with the respective parties?

A Yes, they were.

Q And at any point in time, did any information come to your attention to contradict that impression?

A No, sir.

Q Now, did from time to time you have any conversations with any representative of Allen & Company, Inc. concerning those transactions?

MR. POLLACK: May we have the question, please?

(Question read.)

MR. POLLACK: When?

MR. CRACO: I said at any time.

A I can recall none specifically.

Q Did you ever attend a meeting at the offices of Allen & Company, Inc. concerning those transactions?

A Not that I recall.

Q Did you ever discuss with Allen & Company, Inc. the accounting treatment to be accorded those transactions or either of them?

A No, sir.

Q Do you know Lee Meyer?

A Yes.

Q Who was Lee Meyer in November of 1959?

A To the best of my recollection, he was still a director of the Firestone Group and a vice-president at one of the Allen entities. I don't recall which of the companies.

Q Did you have any conversations with Mr. Firestone

either in his capacity -- well, did you ever have any conversation with Mr. Meyer about the Monterey Nursing Homes transaction?

A Not specifically.

Q Did you ever have any conversations with him about the Monterey Nursing Homes transactions or the accounting treatment that was to be accorded to them?

A No.

Q Were you ever present when Mr. Meyer had any conversations either in person or in byphone with anyone else about that subject?

A No, I was not.

Q Do you know a gentleman by the name of Scharff?

A Yes.

Q Who is he?

A Allen Scharff was our business manager, our general business manager.

Q When you say "our general business manager," you mean the Firestone Group?

A Yes.

Q Was he also financial adviser to Mr. Firestone, to your knowledge?

A I don't know whether he was a personal adviser, but he was a general adviser to the company.

Q Were you ever present when Mr. Scharff discussed withanyone else the accounting treatment to be accorded those transactions?

A I can't remember specifically.

Q I mean to include in that both personal and telephonically.

A I understand.

Q Did you ever discuss the accounting treatment that was to be accorded those transactions or either of them with any representative of Laventhol, Krekstein, to your best recollection?

A Yes, to a degree.

Q All right. With whom did you have that conversation?

A I believe it was with Mr. Jerry Gottlieb of the Laventhol office.

Q Who was Mr. Gottlieb at that time, if you recall?

A I believe he was the SEC representative -- this was what I thought he was -- for L.K.H.& H.

Q When did you have that conversation with Mr. Gottlieb?

A The approximate time was the end of November, I believe. I am not specifically sure of the date.

Q Where did the conversation take place?

A In my office.

Q Was anybody else present?

A Possibly Mr. Schwalb from time to time.

Q Mr. Schwalb also associated with Laventhol?

A Yes, he was.

Q To the best of your present recollection, would you tell us what you said to Mr. Gottlieb and/or Mr. Schwalb and what they said to you on the occasion of that conversation?

A Generally speaking, it was my position to submit the contracts of sale and go over varied points within them with the auditors, with Mr. Gottlieb and Mr. Schwalb, relative to varied exhibits we would have to attach to the agreements and giving them for their audit original copies of documents.

2b Q Did they ask for that meeting?

A Excuse me? Did they ask for that meeting?

Q Yes. Was the meeting set up at their request?

A I don't remember which.

Q In any event, did they ask you questions about the purchase of the Monterey Nursing Homes in the course of that conversation?

A Yes.

Q And did you answer them truthfully to the best of your ability?

A Yes.

Q Did they ask you questions about the sale of the Monterey Nursing Homes, and did you answer them truthfully to the best of your ability?

A Yes.

THE COURT: Of course this isn't very valuable evidence. What was said? You haven't asked him what the conversation was. So far you haven't asked him that.

MR. CRACO: I want to establish that inquiry was made about the bonafides of the transaction.

THE COURT: I understand what you are doing.

MR. HAIMOFF: May we have a date, your Honor?

MR. CRACO: He testified it was at the beginning of November.

THE WITNESS: Some time in November. I can't pinpoint the exact timing.

Q What did they ask you and what did you tell them about these transactions, as best you presently recall?

A Who initiated the agreements, who initiated the negotiations on both the price and the terms, and I had advised them that Mr. Firestone had initiated both the initial agreement to purchase from Monterey as well as the subsequent contractof sale between ourselves, the Firestone Group, Ltd., and Continental Recreation; and I had advised them that yes, I believe it was Mr. Ruderian who personally signed the agreement as president of the purchasing entity, and I don't recall who signed it on the Firestone Group, Ltd.'s behalf, but I just verified the fact that I believe it was the president of Monterey Nursing Inns who had executed the selling agreement, and that I was to be dealing with Mr. Abramowitz who, I believe, at that time was the president of Monterey as to acquiring all the documentation in order to fulfill the requirements within the contract, namely, the title reports and legal descriptions, things such as that, whatever items the contract called for.

Q Was that the substance of your conversation?

A Basically, yes.

SOUTHERN DISTRICT COURT REPORTERS
UNITED STATES COURT HOUSE
FOLEY SQUARE, N.Y., N.Y. 10007 TELEPHONE: CORTLANDT 7-4580

Q Did they ask you to produce documentation including the originalsof the contracts?

A Yes.

Q Did you do so?

A Yes, I did.

Q Did you have any conversations with Mr. Wadley about these transactions at or about the same time?

A I don't recall any specifically, no.

Q Did there come a time in December, 1969, and I am asking this question in a leading form to refresh the witness's recollection, when you and Mr. Meyer and Mr. Scharff had a joint telephone conversation with Mr. Lipkin and Mr. Chazen of Laventhol, Krekstein concerning the accounting treatment to be accorded the transactions that we have been talking about?

A I don't remember the call specifically, no.

Q Do you remember it generally?

A No.

Q Do you remember such a conversation if I add to it that in the course of that conversation Mr. Meyer and Mr. Scharff and yourself requested that Laventhol revise its treatment of the Monterey transaction so as to take into current income the entire of one million, seven hundred-odd thousand dollars that it had displayed as

deferred income in the audited statement it rendered? Do you recall that conversation?

A I don't remember it specifically or generally. It could very well have taken place, but a lot of things have happened then, both relative to this issue today and other things.

Q Let me make sure I understand. It's not your present testimony that you deny such a conversation took place?

A No, I don't deny it, but I don't recall it specifically or generally.

Q Was there any occasion to your memory in which representatives of Firestone asked Laventhol to include in the current income the entire amount of the profit from the sale of the Monterey Nursing Homes?

A Yes, but I don't recall whether the terminology that you used now was the same.

Q Use your own terminology.

A I remember Mr. Firestone mentioning or inquiring as to why the entire difference between the purchase prices could not be included, and I don't remember distinctly what the answer was, but I know what the effect of the answer was.

Q What was the effect of the answer?

A That it could not be.

Q And Laventhol refused to change the financial statement in that respect, did it not?

A I don't know whether they refused to. I don't know whether it was relative to the first one or getting back the first one, since I was not involved in that issue of --

Q Right. Do you recall that this conversation took place after the rendition of the December 6, 1969, audited financial report, which is Exhibit 7 in evidence?

A Sir, I don't remember the exact dates. I just don't remember the exact dates.

Q Isn't it fair to say, sir, that after Laventhol took the position that a million, seven of the profit had to be deferred, the Firestone Group, Ltd. exerted its efforts to try to get Laventhol to change its mind so as to include in current income the entire profit?

A It would be a fair assumption to make that.

Q That is the fact, isn't it?

A When you say the fact --

Q That happened, didn't it?

A Yes, sir, it did.

Q And in point of fact, was not Lee Mayer present on one of the occasions when that effort was made?

SOUTHERN DISTRICT COURT REPORTERS
UNITED STATES COURT HOUSE
FOLEY SQUARE, N.Y., N.Y. 10007 TELEPHONE CORTLANDT 7-4580

A I don't recall Lee Meyer being in the same room with myself and any of the Laventhol people at the same time. I remember meeting, I believe, Mr. Chazen with Mr. Firestone, but I do not recall whether or not Mr. Meyer was present.

Q Do you recall Mr. Meyer being present with you in the absence of the Laventhol people during a telephone conversation about the subject that you now say did come up?

MR. POLLACK: Object, repetitive. The question has been asked and answered.

MR. CRACO: I am pressing the witness for his recollection.

A I don't recall. I don't believe we had ever been together in a room regarding that.

Q Did you ever discuss this subject with Lee Meyer, and by this subject I mean the treatment of the deferred income by Laventhol with Lee Meyer, to your recollection?

A To my recollection, I did not.

Q I show you Exhibit E in evidence and I ask you whether it bears your signature.

A Yes, it does.

MR. CRACO: Your Honor, this is the letter of

MR. CRACO: Your Honor, this is the letter of May 26, 1970, from the Firestone Group to Laventhol, Krekstein in connection with the January 31, 1970, audit.

Q I show you now Plaintiffs' Exhibit 9 in evidence, the annual report to the shareholders for 1970. I ask you to have that before you for the moment while I finish my last few questions.

In particular, I ask you to look at the balance sheet. Do you find on the balance sheet of January 31, 1970, audited statements of Firestone an amount for deferred charges?

A Yes.

Q What is that amount?

A $1,159,035.

Q I ask you to direct your attention to the income statement and ask you if you find on the income statement a line for the audited statement as at January 31, 1970, for deferred gross profit?

A Yes.

Q What is that amount?

A $1,795,500.

Q There is a reference to a footnote 2?

A Yes.

Q Are you familiar with that footnote?

A Yes, I am reading it right now.

Q That footnote is substantially identical, is it not, with footnote 4 in the November 30, 1969, statement which had been prepared for an accounting period that had ended two months before the one for which Exhibit 9 was prepared?

MR. POLLACK: Objection, your Honor. The documents speak for themselves.

THE COURT: Sustained.

Q Do you know them to be substantially identical with the exception of the postponement from January 30 to July 1, 1970, of a final payment?

MR. POLLACK: Objection. The documents speak for themselves.

MR. CRACO: I am asking about the witness's understanding of that fact, if your Honor would take it subject to connection.

MR. POLLACK: I press the objection.

THE COURT: His understanding.

A They look very similar except for that item, yes.

THE COURT: The answer is not responsive. Strike it out.

SOUTHERN DISTRICT COURT REPORTERS
UNITED STATES COURT HOUSE
FOLEY SQUARE, N.Y., N.Y. 10007 TELEPHONE: CORTLANDT 7-4580

Q Are they the same and did you understand them to be the same?

A I understood --

MR. POLLACK: Objection. How can he speculate on that now without looking them over?

MR. CRACO: All right. I withdraw the question.

Q In the letter of May 26, 1970, which you signed, Defendant's Exhibit E, I ask you whether this letter was furnished to Laventhol for the purpose of Laventhol's reliance upon it in connection with the audit of January 31, 1970.

MR. POLLACK: Objection, irrelevant, and also, how can he know the purpose?

THE COURT: Could I have the question?

(The pending question was read.)

THE COURT: If the witness knows, he may answer.

MR. CRACO: He signed it and sent it, Judge.

A Yes.

Q It was prepared for that purpose?

A Yes.

Q I draw your attention to the fifth paragraph on the first page which reads, "Deferred costs in the amount of $1,159,035 are considered to be properly chargeable to operations of future years."

Do you see that?

A Yes.

Q Was that statement true in your judgment when you executed that letter?

A To the best of my belief, it was at that time.

Q Did you intend Laventhol to rely upon that statement as part of its consideration in including in the balance sheet the amount of $1,159,035 in Exhibit 9?

A I don't know what they would rely on, but I gave this in good faith.

Q But that is what you intended them to do, was it not?

A I intended them touse that, yes.

Q Would you look at the last paragraph of Exhibit E, which reads, "We further represent to you that all transactions and commitments have been conducted and completed on an arm's-length basis."

Was that statement true?

A Yes.

Q Was it true when you executed this letter?

A Yes.

Q And it was true as at January 31, 1970, wasn't it, the date as of which this letter spoke?

A It was true throughout that period of time.

SOUTHERN DISTRICT COURT REPORTERS
UNITED STATES COURT HOUSE
FOLEY SQUARE, N.Y., N.Y. 10007 TELEPHONE CORTLANDT 7-4580

Q Has there been anything that has come to your attention from that date to this that leads you to a different conclusion as to the arm's-length basis of the transaction which is involved here, the purchase and sale of the Monterey Nursing Homes?

A No.

MR. CRACO: Your witness.

MR. POLLACK: No questions, your Honor.

MR. HAIMOFF: I have a few questions, your Honor.

BY MR. HAIMOFF:

Q Mr. Scott, do I understand that the first time this Monterey transaction came to your attention was when you saw the agreements that you referred to?

A Yes.

Q The agreement for the purchase by Firestone from Monterey is dated November 22, 1969. Is that the date when you saw the agreement for the first time or was it before that or after that?

A I don't recall the exact date I saw the agreement.

Q Were you present when the contract was signed?

A No, I was not.

Q When you saw it it had been signed, is that correct?

A Yes, I believe so.

Q Can you tell me whether or not you saw both the Monterey-Firestone contract and the Firestone-Continental contract at the same time?

A I don't recall precisely. I believe I saw them within the same period of time, maybe the same day, or maybe the same moment, but --

Q Well, I call your attention to the fact that the contract between Firestone and Continental is dated November 26, 1969. Does that refresh your recollection that you saw

both contracts on or about November 26, 1969?

A It was sometime in November. I still don't remember the exact date.

Q It wouldn't be before November 26th, would it, that you saw the Continental contract?

MR. CRACO: I object to the form of the question as argumentative.

MR. HAIMOFF: This is cross examination, your Honor.

THE COURT: All right, overruled. I am aware it is cross examination.

MR. HAIMOFF: Yes, sir.

A No, I assume it was after the 26th.

Q Were you present when the Continental contract was signed?

A No, I was not.

Q Did you meet the person who signed the contracts on behalf of the Monterey Nursing Institute, Inc.?

A Yes, at a subsequent date.

Q Subsequent to November 26th?

A Yes, I believe so.

Q How long after November 26th did you meet this person?

A I believe it was a month, month and a half.

Q I show you a paper which has been marked Plaintiff's Exhibit 17 in this case, and ask you whether you ever saw it before.

A No.

Q Do you observe that this memorandum purports to have been prepared by a D. L. Amberson?

A Yes.

Q Who is D. L. Amberson?

A That was Donna Amberson that worked for the Firestone Group.

Q In what capacity?

A Donna had come to us in order to set up and handle the processing of escrows of all of our purchases and sales.

Q Would it be fair to say that she functioned as your assistant?

A It would be fair to say that everyone functioned in their own way except when Mr. Firestone wanted something done of them directly.

Q I don't quite understand your answer. Was she or was she not your assistant?

A When it came to certain matters, yes.

Q Now you have indicated that you went about getting certain exhibits.

A Yes.

Q And I think you have indicated that the exhibits that you got had to do with descriptions of the various properties?

A Legal descriptions, zoning prerequisites, requirements, things like that, yes.

Q When you got those descriptions what did you do with them?

A We looked them over and according to the agreements, we were required to furnish the same things to Continental Recreation on their purchase from us as we were requesting from Monterey so I would photostat them, package them and send them to Continental for their inspection.

Q Did you tell me when you obtained the descriptions that you have referred to?

A It was not right away since the properties were all scattered throughout the country, and we were in touch with varied people at different title companies and different law firms in different states.

I don't remember exactly when but it was not the following week or two weeks. It was a later date. I don't know the precise date.

Q Can you tell me now whether it was in January or February of 1970?

A I believe it was in January some time.

Q Did you subsequently deliver those descriptions to the Laventhol firm?

A Not to the Laventhol firm. I believe I delivered them only to Continental Recreation.

MR. HAIMOFF: I have no further questions.

MR. CRACO: I just have two very brief ones I hope.

RECROSS EXAMINATION

BY MR. CRACO:

Q I show you Exhibit D which is the undated representation letter from the Firestone group to Laventhol. I believe this morning you identified your signature at the time that I offered that.

A Yes.

Q Are you able to tell the Court approximately when that letter was transmitted?

A It had to be or probably was prior to the end of calendar 1969 since it refers to certain entities which were in the process of being negotiated, such as the Housing Resources Corporation 10 per cent interest to a specific employee.

MR. POLLACK: I move that the answer be stricken as speculative.

THE COURT: Overruled.

MR.CRACO: Thank you.

You were referring to the two contracts. May I have them?

(Mr. Haimoff hands papers to Mr. Craco.)

Q Was the acquisition by the Firestone Group of the properties refarred to in the agreement of sale which is Exhibit 12, from Monterey Nursing Institution, subject to leases that were subsisting on those properties in favor of certain tenants?

A Could you explain that again?

Q Well, were there leases on the properties that were covered by these contracts?

A Yes, I believe so.

Q And is it your best recollection that those leases were matters which you knew about in the course of your investigation of these matters?

A Yes.

Q Were there actually occupants, occupying the premises pursuant to those leases?

A Yes.

Q And your purchase, Firestone's purchase of the properties was subject to the leases, was it not?

A Yes.

Q And your sale of the properties to the Continental Recreation Company was also subject to those leases, was it not?

A Yes.

Q And did you tell all that to the Laventhol people when they asked about the terms of the deal?

A I told them all the terms of the deal.

Q Including that one?

A If that was one of them, I told them that, yes.

Q Your testimony is to the best of your memory it was one of them, right?

A Yes.

THE COURT: Any further questions? You have the right to ask yourself a question or make any statement you care to Mr.Scott.

MR. SCOTT: I think I have covered the material quite sufficiently, your Honor.

THE COURT: Anything you want to say, you can say it now.

MR. SCOTT: I'd like to be able to leave to go catch an airplane.

THE COURT: All right. Granted.

You understand your voluntarily waiving your rights to remain?

MR. SCOTT: I understand, your Honor.

THE COURT: You also have the right to submit a written argument at the close of this case. It would be probably within 30 days of this case that you would have to submit a written brief if you wish.

MR. SCOTT: I understand.

THE COURT: All right?

MR. SCOTT: Thank you.

(Witness excused.)

C H E S T E R P. W A D L E Y, resumed the stand and testified further as follows:

THE COURT: You are still under oath.

CROSS EXAMINATION

BY MR. CRACO:

Q I show you Exhibit F which was marked on your cross examination, and I ask you whether, among the documents you were asked to gather for the auditors in preparation for the audit, with a complete schedule of all proposed syndications?

A Yes.

Q As referred to in item 5F?

A Right.

Q Right?

A I understand that's in the letter.

Q Did you attempt to comply with that request?

A I did. I was unable to comply with it.

Q Why were you unable to comply with it?

A The information was not made available to me.

Q By whom?

A By Mr. Firestone.

Q So that if anyone wanted to get that information, they would have to get it from Mr. Firestone and not from you, right?

A That is correct.

Q I know that you were also requested to procure in item 5G a complete schedule of fixed commitments to purchase land or other assets. Did you attempt to get that information?

A I did.

Q I beg your pardon?

A I did attempt to get it.

Q Did you in fact get it?

A No.

Q Was that for the same reason that you assigned to the previous?

A That was the same reason. Mr. Firestone did not make the documents available to me.

Q And if someone wanted to get these, he

would have to get them from Mr. Firestone and discuss the heart with Mr. Firestone directly, is that correct?

A That is correct.

Q While we are on the subject of Mr. Firestone, I believe you testified, and I want to make sure I heard you correctly, the fact is that Mr. Firestone always kept his office door locked, isn't it?

A Yes, that is true.

Q So that if he were in ther[illegible]sing business with somebody, it would have been no[illegible]ot abnormal for the door to have been locked?

A That is correct.

Q And it didn't necessarily indicate to you as someone who knew his habits that some dark secret was being concluded inside; is that correct?

A That is correct.

Q Now, I understood your testimony to be that you did not know about the transactions in respect to the Monterey Nursing Homes in November of 1969. Is that true?

A I know there was an escrow deposit of $5,000 from Monterey. I did not know what it was for. I booked it as escrow deposit.

Q Tell me again, would you please, what your position and responsibilities were in November of 1969.

A I was in charge of accounting, personnel, and general administration.

Q Did you have a title?

A Controller.

Q Did have anything to do with the preparation of financial statements in connection with your responsibility for accounting work?

A We issued no financial statements other than the ones prepared by LKH and H.

Q Could I have the question answered directly, please.

THE COURT: Yes, read it.

MR. CRACO: May I have it reread, please.

(The question was read.)

A They are ethically, yes.

Q And if Firestone had issued financial statements other than those audited by LKH and H, you would have had some responsibility with respect to them, is that right?

A I would have, yes, sir.

Q Now I show you Exhibit 2 for identification, which is a note and stock purchase agreement of the Firestone Group, Ltd., and I direct your attention to Exhibit B of that agreement which purports to be a calculated projected balance sheet and calculated projected statement of income for the 11 months ended November 30, 1969, unaudited, and I ask you whether that is not in fact a financial statement issued by Firestone unaudited by LKH and H during this period?

A That is true.

Q Did you have anything to do with the preparation of that statement?

A I did have something to do with the preparation of that.

Q What did you have to do with the preparation of it?

A I prepared some figures for Mr. Firestone based on the figures that he gave me.

I don't know if this is the same or not. I gave them to Mr. Firestone in pencil and I don't know what happened to them.

Q Did you ever talk to anybody at LKH and H about these statements prior to, say, November 15, 1969?

A No, I did not.

Q Did you read these financial statements before

they found their way into print?

A No, I did not, sir.

Q Did you read them after they found their way into print?

A Yes, I did.

Q Did you notice the figure on the projected statement of income for land and income producing property sales?

A Yes.

Q What was that amount?

A $17,700,000.

Q Did you know at the time that you read that where the $17,700,000 of sales came from?

A No, I did not.

Q Notwithstanding that you were responsible for financial statements issued other than those audited by LKH and H, you did not know where the sales figure came from, is that correct?

A That is correct, I did not know where it came from.

MR. POLLACK: Objection.

THE COURT: Could I have the questi-n again, please.

MR. CRACO: I will withdraw the question.

Q Did you know what the sales of the company

were as at November 30, 1969?

A The actual sales that I had booked, yes.

Q Did they amount to $17,700,000?

A No, they did not.

Q What did they amount to?

A Some six million dollars.

Q Did you ask Mr. Firestone where the balance of those sales came from?

A Yes, and he said that he will take care of that.

Q So you don't know where those additional sales came from?

A No.

Q And you didn't when the financial statements went out?

A That is correct.

Q And if somebody wanted to know where those additional sales came from or anything material about them, I guess he had to ask Mr. Firestone and not you, is that right?

A That is quite correct.

Q And that includes Laventhol?

MR. POLLACK: Objection; speculation.

Q If Laventhol wanted to find out about those additional sales they would have had to ask Mr. Firestone, not you, right?

A Right.

MR. POLLACK: I ask the question and answer be stricken. He is not obliged to speculate.

THE COURT: Sustained.

MR. CRACO: May I be heard briefly on that, your Honor?

Mr. Pollack adduced testimony that Laventhol never questioned the man about this transaction. I am trying to show that Laventhol had an accurate sense of who to ask about this transaction and that their failure to ask him was the result of his having nothing to do with it.

They tried to paint some dark picture about that.

THE COURT: The question is improper and the answer is improper and it is stricken. The argument may be a perfectly valid one based on the other facts that you have.

Q Is it accurate, just so the record is correct, that the two sales -- that the sales that you had booked on your records were two sales aggregating $6,739,000, one of them involving Barque Boro and one involving Huero Crema, is that right?

A That's Crow.

Q It is Crema in Spanish, isn't it?

A Yes, sir.

Q And those were the only sales you had booked?

A That is correct.

Q And you didn't know anything about any others?

A I did not.

Q And that is true even though a financial statement was put out in a note in the stock purchase agreement by the company of which you were the controller?

A That is correct.

Q Now, did you have anything to do with the underwriting through Allen & Company in connection with which this note to stock purchase agreement was prepared and disseminated?

A I did not.

Q Did you talk to anybody at Allen & Company about it?

A No, sir.

Q Did you talk to Mr. Meyer about it?

A Never met Mr. Meyer?

Q In your life?

A No, sir.

Q Did you talk to Mr. Scott about it?

A No, sir. It was not in my area of operations.

Q Did you ever talk with Mr. Scott about the purchase and sale of the Monterey Homes at all?

A At a later time.

Q How much later?

A After I obtained the journal entries, putting them on the books as a purchase and sale, I then asked Mr. Scott for the documents or copies of them.

Q Did you get them?

A No, I did not.

Q Did you remonstrate with Mr. Scott about not giving them to you?

A He said he was ordered not to give them to me.

Q By whom?

A By Mr. Firestone.

Q Did you discuss with Mr. Scott at any time the treatment afforded those transactions on the audited statements of Firestone for the period ending November 30, 1969?

A I asked for the documents rather than a discussion.

Q You told us about that and what became of it.

Did you ever talk with Mr. Scott about the accounting treatment accorded those transactions in the audited statements for the period ending November 30, 1969, yes or no?

A I would say no.

Q Did you have any responsibility internally in Firestone for following up on the implementation of either

the purchase of the Monterey properties or their sale?

A No, sir.

Q Do you know who did?

A Mr. Scott.

Q I show you Exhibit E dated May 26, 1970, and ask if in addition to Mr. Scott's signature at the bottom of page 2 yours appears?

A Thatis my signature.

Q And when you signed it, did you intend that letter to be conveyed to Laventhol, Krekstein for the purpose of their relying upon it in the course of preparing an audit opinion for the period ending January 31, 1970?

A It had to have been written for that purpose. There is no question about it.

Q That is why you signed it?

A Yes.

Q And that was for a period ending some two months after the audited statements involved in this litigation, is that right?

A That is correct.

Q Now, you are familiar with the fact, are you not, Mr. Wadley, that a representation letter of this character speaks as of the last date of the accounting period for which the audit is being given, is that right?

A That is correct.

Q So that this set of representations was intended to convey to Laventhol your understanding of the state of facts as at January 31, 1970, is that right?

MR. POLLACK: I object. The document speaks for itself.

THE COURT: Overruled.

A The items on the books at January 31, 1970, follow the course of procedure that was established by LKH and H in the audit in December. So there was no change in procedure from the audits that they made and the additions that were made in that audit.

THE COURT: The answer isn't responsive.

MR. CRACO: I don't think it is, your Honor.

May I reframe the question? Perhaps the witness didn't understand it.

Q To the extent that they purport to be representations in this letter, the representations that you signed were supposed to be true as at January 31, 1970, isn't that right?

A Yes.

Q And you intended Laventhol, Krekstein to understand that they were represented by you to be true as of that date?

A Yes.

Q And is that true with respect to the statement on page 1 in the fifth paragraph -- either not numbered but it is the fifth one by count: "Deferred cost in the amount of $1,159,035 are considered to be properly chargeable to the operations of future years"?

A Yes.

Q And was it also true of the last paragraph of the letter, "We further represent to you that all transactions and commitments have been conducted and completed on an arm's length basis"?

A Yes.

MR. POLLACK: Is that letter in evidence?

MR. CRACO: It is Exhibit E. Does it bear -- if there is any doubt it has been offered, I offer it if it hasn't been before.

I believe it to be already offered into evidence.

THE COURT: We will take a short recess.

MR. CRACO: I am thoough with this witness after this exhibit.

THE COURT: We will take a short recess.

(A recess was taken.)

MR. CRACO: Your Honor, for the sake of the record, I have shown Exhibit E, the letter of May 26, 1970, to all counsel. I now offer it in evidence.

THE COURT: Received.

(Defendant's Exhibit E received in evidence.)

REDIRECT EXAMINATION

BY MR. POLLACK:

Q Mr. Wadley, this morning when I asked you questions on direct examination --

THE COURT: I am sorry, Mr. Pollack, I don't mean to interrupt you. When you turn your back I can't hear you, and I don't think the court reporter can.

MR. POLLACK: Yes, sir.

THE COURT: So keep facing the Court.

Q Mr. Wadley, this morning when I asked you questions on direct examination, you said that you received instructions to put the Continental transaction on the books from Laventhol on the 18th or 19th of December through Mr. Schwalb's letter. I then showed you certain journal entries which accompanies the letter. You testified that you received them, and that indeed you received certain others.

The journal entries that I showed you were A-19.

I now show you A-11, 12 and 13, and ask you whether those were the additional ones that you received with the Schwalb letter, which is A-14.

A These are.

MR. POLLACK: I offer them in evidence.

MR. CRACO: May I see them?

(Papers handed to Mr. Craco.)

THE COURT: Received.

(Third-Party Defendant's Exhibits A-11, A-12, and A-13 received in evidence.)

Q Mr. Wadley, Mr. Craco asked you certain questions about Exhibit E. I now ask you whether you had any participation at all in the preparation of the January 31, 1970, financial statements.

A No, I did not.

Q At the time of this letter which is dated May 26, 1970, and I am referring to Exhibit E, were you still the treasurer or controller of Firestone?

A No, I was not.

Q When had you resigned?

A February 28.

MR. CRACO: Of what year, if I may ask?

THE WITNESS: February 28, 1970. I am sorry.

Q At January 31, 1970, did you have any information

in your possession about the nature of the Continental Recreation transaction?

A No, I did not.

Q Other than the journal entries which Mr. Schwalb had told you to make; is that correct?

A That is correct.

Q Were you asked to sign this letter, Exhibit E?

A Yes, I was.

Q Was it given to you to sign the week that you left the company?

A Yes.

Q Did you make any investigation in connection with this letter?

A I did not. I was negligent in that respect.

MR. POLLACK: I move that the comment be stricken after "I did not."

THE COURT: Yes, strike the comment.

Q You testified with respect to Exhibit F, which is the letter to you from Mr. Schwalb dated November 17, 1969, purporting to summarize your discussion of that morning. You testified that you were unable to fulfill the items 5f and 5g. Did Laventhol ever ask you why you had not completed --

A Yes.

Q -- item 5f and 5g?

A Yes, they did.

Q Who asked you?

A Mr. Schwalb.

Q What did you say?

A I told him that I could not get the information.

Q Did he say anything further?

A No.

Q Mr. Wadley, please tell the Court your business background prior to your position at Firestone.

A I am a CPA, graduate of Northwestern University. I was with Peat, Morwick, Mitchell for a couple of years.

Then I became the controller with the W. Long Company in Chicago. Then I was treasurer of Club Aluminum Products Company.

Then I went with Huber Homes, a large residential builder in Dayton, Ohio, and then I was with Lewis Homes, a builder in Pomona, California, and then I joined the Firestone Group.

Q Approximately how long had you been a controller?

A I had been a controller or a corporate officer --

Q Excuse me -- or in the financial area of corporate life?

A 25 years.

MR. POLLACK: No further questions.

MR. CRACO: Just a very brief recross.

RECROSS EXAMINATION

BY MR. CRACO:

Q With respect to Exhibit F, the letter which listed the requests from Mr. Schwalb, when he asked you why you weren't able to get the information and you told him why you didn't get the information, and you told him that you weren't able, did you also tell him what steps you had taken to try to get it?

A Yes, I did.

Q So is it fair to say that at the end of your communication with Mr. Schwalb on this matter, he knew that Mr. Firestone was the place to go to get the information?

A That is correct.

Q I believe you testified that Exhibit E was a letter which was sent to Laventhol for the purpose of their relying on it in giving their audit statement and their audit opinion with respect to the January 31, 1970, statement; isn't that true?

A That's correct.

MR. POLLACK: I object and I renew my objection as to the document. It speaks for itself.

MR. CRACO: I am getting the purpose of it.

THE COURT: The question is repetitive. That is the Court's objection to it.

MR. CRACO: It's just a foundation for the next question.

THE COURT: I know it, but we have had about 40 foundations Mr. Craco, and I would appreciate making some progress in this case. I think I have been overly patient, especially for me.

Q Are you telling this Court that you held yourself out on May 26, 1970, to be the treasurer and controller when you signed the letter in that capacity although in fact you were not?

A That is correct.

Q Did you not intend Laventhol to believe you to be the treasurer and controller when you signed the letter?

A I am quite sure that they knew I was not.

Q Did you intend Laventhol to believe you to be signing the letter in that capacity although you no longer occupied it?

A I don't remember even signing the letter, sir.

Q It is your signature, is it not?

A It's my signature.

Q Did you resign on February 28, 1970, in writing?

A Yes.

Q Do you have a copy of that with you?

A No, I don't.

MR. CRACO: Do you, Mr. Pollack?

MR. POLLACK: No.

Q Are there any other representations in this letter that you signed other than your capacity which are untruthful?

MR. POLLACK: Objection to the form of the question.

THE COURT: To the witness's knowledge untruthful.

A You want me to answer that question, sir?

Q If you would.

A I had no knowledge of the January 31, 1970, financial condition. I was no longer active in the accounting department at the time of this letter.

THE COURT: Are you telling us that a letter went out over your signature when you didn't know whether the figures and statements contained in that letter were accurate or not? Is that what you are telling us?

THE WITNESS: That's true.

Q And that is this letter?

A That is the letter.

MR. CRACO: That is all.

MR. POLLACK: No further questions.

THE COURT: You are excused.

(Witness excused.)

MR. POLLACK: Mr. Sam Winograd.

S A M W I N O G R A D, called as a witness on behalf of the third-party defendant Allen, being first duly sworn, testified as follows:

DIRECT EXAMINATION

BY MR. POLLACK:

Q Mr. Winograd, are you the president of Transcontinental Resources, Inc.?

A I am.

Q Is Transcontinental Resources, Inc. the successor name company to the Firestone Group, Ltd.?

A It is.

Q When did you become president of Transcontinental Resources, Inc.?

A I believe it was in the early part of June, 1971.

Q Was it then called the Firestone Group, Ltd.?

A It was.

Q At the time that you became president, did you also become treasurer?

A I did.

Q Did you, at the time you became president and treasurer, acquire control of certain books and records of the Firestone Group, Ltd.?

A I did.

Q Did those books include the corporate minute books?

A They did.

Q Do the corporate minute books of the Firestone Group, Ltd. for 1969 and 1970 make any reference whatsoever to a $15,000,000 by the Firestone Group, Ltd. to Continental Recreation Company?

A They do not.

Q Do the corporate minute books for 1969 and 1970 of the Firestone Group, Ltd. make any reference whatsoever to a $13,000,000 purchase by Firestone from Monterey Nursing Inns, Inc.?

A They do not.

Q Is this book the corporate minute books of the Firestone Group, Ltd., and as it is now known, Trans-continental Resources, Inc.?

A That is so.

MR. POLLACK: Your Honor, I do not think it necessary to offer the entire minute book in evidence.

I would like to show it to Mr. Craco, I would like to show it to the Court, and your Honor will observe from thumbing through those minutes that there are no minutes reflecting either of these transactions.

THE COURT: Just let's have the minute book deemed marked for purposes of cross-examination. There is no sense in encumbering the record.

MR. POLLACK: Good. I offer deemed marked Exhibit A-21.

(Third-Party Defendant's Exhibit A-21 deemed marked.)

MR. POLLACK: Your Honor, shall I proceed?

THE COURT: Sure.

Q Mr. Winograd, is there any corporate resolution in the corporate minute books or elsewhere in the files of the Firestone Group, Ltd. approving a purchase by Firestone from Monterey Nursing Inns of $13,000,000 of Nursing Homes?

A No such resolutions have been found in any of our corporate records.

Q Is there any such resolution approving a sale of $15,000,000 of Nursing Homes to Continental Recreation Company?

A We have found no such resolution.

Q Did I also ask you to bring the books of original

SOUTHERN DISTRICT COURT REPORTERS
UNITED STATES COURT HOUSE

entry for the Firestone Group, Ltd. for November and December, 1969?

A You did.

Q How did you respond to me?

A I directed a search of the files at our headquarters, and we have been unable to locate any such books.

Q At the time that you became president of the Firestone Group, Ltd., what was the state of the records of that company ?

A The status of the records, Mr. Pollack, was in a chaotic condition, I guess partly due to the fact that the company was a petitioner in a Chapter XI proceeding in the Federal Court in Los Angeles, and some records were in the hands of receivers, some in a storage room, some at our small headquarters. It was absolutely chaotic.

Q You speak of a reorganization. When was that?

A I beg your pardon?

THE COURT: What was the date?

MR. POLLACK: Of the reorganization?

THE WITNESS: I understand your Honor. The petition in Chapter XI --

THE COURT: When you found the records in this state, when was that?

THE WITNESS: Between April 2, 1971, and October

1, 1971, your Honor.

THE COURT: All right.

Q Did you locate books of original entry for the period November and December, 1969?

A We have been unable to locate them.

Q In connection with the reorganization of Firestone in the Federal Court in California, how much did the holder of each unit from the private placement of December 16, 1969, obtain?

MR. POLLACK: I remind the Court that each unit consisted of $250,000 of notes and 5000 shares of common stock.

A Mr. Pollack, the holders of the 5000 shares of common stock in the plan of arrangement were reverse split ten to one, and when the Court approved the plan of arrangement, the 5000 shares of old common became 5000 shares of new common.

With respect to the $250,000 of note, that $250,000 of debt was converted into 25,000 shares of preferred stock callable at $10 a share and convertible into one share of preferred for two shares of common at the option of the holder of the preferred.

Q Mr. Winograd, is there any record of the Firestone Group, Ltd., to your knowledge, indicating that the purchase

SOUTHERN DISTRICT COURT REPORTERS
UNITED STATES COURT HOUSE

from Monterey Nursing Inns was ever actually made?

A We have found no record to indicate that a sale was consummated.

Q A purchase is what I asked you about from Monterey.

A We have found no record of any purchase.

Q Have you found any record of any sale to Continental Recreation Company?

A We found no such record.

MR. POLLACK: No further questions, your Honor.

MR. CRACO: Bear with me for one moment, your Honor.

CROSS EXAMINATION

BY MR. CRACO:

Q So that I am sure we all understand the last couple of answers you gave, Mr. Winograd, did you see the two contracts which are Exhibits 12 and 13?

A I have, Mr. Craco.

Q I take it then that your answer to Mr. Pollack mean: that you found no record that indicated that the respective purchases and sales had closed in accordance with the terms of those contracts?

A That is correct.

Q When did you say you became president of Firestone

SOUTHERN DISTRICT COURT REPORTERS
UNITED STATES COURT HOUSE

Group, Ltd.?

A I first became president of that company, Mr. Craco, I think it was around June of 1971; and thereafter I became chairman, we elected a new president, and as of about a month ago I became the president again.

Q Mr. Winograd, in the course of all of that, did there come to your attention the fact that certain books, records and papers for the period November and December of 1969 with respect to the Firestone Group, Ltd. had been subpoenaed by the Attorney General of the State of New York?

A No, sir.

Q You did not know that?

A No, sir.

Q Did you ask the Attorney General of the State of New York whether he had the records that you couldn't find elsewhere?

A I did not, sir.

MR. CRACO: Thank you. That is all.

THE COURT: You are excused.

THE WITNESS: Thank you.

(Witness excused.)

MR. POLLACK: Your Honor, the next witness will be somewhat lengthy. Could we have five minutes to try